Tax Benefits of Residential Real Estate Investment

There are many different types of investment real estate: rental houses, apartments, vacant land, commercial buildings, industrial, shopping centers or warehouses.

They all offer big tax incentives for investors who understand those benefits.

Many people believe that depreciation is the best real estate tax deduction of all. The IRS REQUIRES real estate investors to depreciate their investment properties.

Depreciation is a "paper loss" required for estimated wear, tear and obsolescence.

However, land value is not depreciable. This applies to 100% of the money invested in buying vacant land and that part of the property value apportioned to land on an improved property. (That is, land with a building on it).

Condominiums do not have a land element and 100% of the purchase price can be depreciated.

Residential income property is depreciated over 27.5 years on a straight-line basis.

Commercial property is depreciated over 39 years, also on a straight-line basis.

Extra tax benefits of being treated as a "real estate professional".

If you are a "real estate professional" who meets certain time requirements and who "materially participates" in managing your investment property, you are allowed almost unlimited income tax-deductions from your investment property.

Time requirement

If you spend at least 750 hours per year, or more than half of your working hours, involved in real estate activities, you probably qualify as a "real estate professional."

There does not appear to be any clear IRS ruling on a semi-retired person with no occupation but real estate to which they devote say, 200 hours a year.

Full-time real estate brokers, realty sales agents, property managers, builders, contractors and leasing agents are examples of qualified real estate professionals. However, the tax law excludes real estate attorneys and mortgage brokers from qualifying. Unless, one must assume, they spend more than 50% of their working hours investing in real estate. This would include managing, buying and selling real estate.

If you invest in real estate but do not qualify as a "real estate professional", you are limited to a maximum annual $25,000 realty investment property loss deduction against their ordinary taxable income. This is called the passive loss restriction. This "loss" includes the paper loss created by depreciation.

There is another catch. If your annual adjusted income exceeds $100,000, the $25,000 loss deduction gradually phases out. At the $150,000 adjusted income level, the allowable tax loss deduction goes to zero.

Any un-deducted real estate investment tax loss is "suspended" for future use, such as at the time the property is sold at a profit. Then you may subtract the unused suspended tax loss from your capital gain to lower the taxable profit. See below.

Material participation requirement

Participation is critical. You can hire a professional property manager and still meet the material participation requirement, and claim the unlimited tax deductions as a professional.

Day-to-day operating details, such as collecting rents, evicting tenants and unclogging toilets, can be delegated to this manager.

But, you must make the major decisions, such as setting rents, approving major expenses and qualifying new tenants. Remember of course the time requirement.

Depreciation of personal property such as appliances

Personal property used in operating the property, such as appliances, is depreciated over shorter periods, typically five to 10 years. Even automobiles and trucks used in the investment operation can be depreciated over their useful lives.

First-year 100% deduction

There is also the new first-year 100 percent tax deduction for up to $100,000 of business equipment purchased. This would include appliances. Sorry but you can't buy a brand new Mercedes and deduct 100% of the cost from your taxes in the first year. But there are special rules for work vehicles, such as trucks. Ask your CPA for more details.

Depreciation is a non-cash deduction

It reduces taxable income from the investment property. But, in contrast to property taxes, mortgage interest, utilities, insurance and repairs, it doesn't require any cash outlay. The depreciation expense deduction can result in a positive cash flow property becoming a loss maker for tax purposes.

Most investment properties go up in value every year, but on paper their value is going down.

Unfortunately, unused tax losses from investment properties cannot be carried back to prior tax years to claim a tax refund.

IRS Notice 88-94 allows use of suspended passive activity tax losses (assuming you do NOT qualify as a professional with material participation) from realty investment assets to offset profits from the sale of the property. The tax result is that you can use suspended property losses on a total basis, rather than property-by-property.

Recapture of depreciation benefits

The maximum capital gains tax rate was reduced to 15 percent in 2003 for assets owned more than 12 months. (If held for less than 12 months gains are taxed as ordinary income.)

However, the IRS requires that you "recapture" the tax saving from your income tax at a special 25 percent depreciation "recapture" tax rate when the property is sold. This apply whether or not you qualify as a "real estate professional."

Example of recapture

Suppose you bought an investment property for $500,000 and deducted $150,000 of depreciation during your ownership years.

That means your book value (also called "adjusted cost basis") declined to $350,000. Then you sold for $650,000.

Your capital gain is therefore $300,000 ($650,000 minus $350,000).

Of that $300,000 capital gain, the $150,000 depreciation deducted will be "recaptured" and taxed at the 25 percent special federal tax rate.

The $150,000 remainder of your capital gain will be taxed at the new 15 percent maximum tax rate.