Tax Benefits of Investing in Real Estate

Cash flow, appreciation, and tax benefits are the three main advantages to investing in real estate. This article focuses on the key tax benefits available to persons investing in real estate properties. The Internal Revenue Code contains many tax provisions that benefit real estate investors. These benefits help defer, reduce, and in certain cases, even eliminate income taxes. These laws can be complicated and difficult for the investor to fully utilize. The purpose here is not to provide all the details of the rules and regulations, but the basic benefits available. Speaking with a tax advisor will help you develop a strategy to benefit your personal situation.

Depreciation: The primary tax benefit of investing in real estate is for the depreciation tax deduction. The role of tax depreciation is to account for the declining physical attributes of a property over time. It is a non-cash tax deduction that potentially shelters or offsets taxable income. The reality is that the physical aspects of the asset usually last longer than the federally allowed depreciation life. Generally, real property's physical attributes will last for a significant period of time. The bigger risk to the investor is that the physical attributes will become obsolete as newer properties will provide better amenities/efficiencies, i.e., an older apartment building without an elevator makes tenants less likely to rent. Another advantage of the tax depreciation rules is that the allowable depreciation deduction is based on the full cost of the asset, even though the buyer may have used bank financing for 80 percent of the purchase price. For example, a real property asset is purchased for $100,000. The buyer puts $20,000 down and finances the remaining $80,000 via a bank owned mortgage. The investor is allowed to take depreciation deductions based on the purchase price of $100,000.

§1031 Exchange: The Internal Revenue Code allows for the deferral of gain "on the exchange of property held for productive use in a trade or business or for investment if such property is exchanged solely for property of like kind which is to be held either for productive use in a trade or business or for investment." This allows real estate property owners a tremendous tax benefit. An investor can exchange a real property that he/she currently owns for another investment in real property. Assuming that certain rules are met, the gain on this transaction is deferred until the subsequently owned property is sold. Investors are often able to defer thousands of dollars in capital gain taxes, both at federal and state levels, by utilizing the 1031 exchange rules. This essentially results in a long-term, interest-free loan from the tax authorities.

Basis Step-Up for Heirs: The certainty of death was properly addressed by Ben Franklin. However, the step-up in basis of assets available to real estate investors at death puts some question to his wisdom about the certainty of taxes. The tax rules allow for the basis of property to be adjusted to its fair market value at the decedent's date of death. Real estate investors can receive significant benefit from this rule. For example, an investor purchases a property for $400,000. Over the course of 30 years, the investor receives depreciation deductions of $325,000. The investor dies and the property's fair value is $1,000,000. The investor's basis is only $75,000, but the decedent's heirs will inherit the property with a basis of $1,000,000. Thus the $925,000 in potential taxable gain has been erased. Furthermore, the heir can start to depreciate the property based on its updated basis of $1,000,000, giving the heir significant non-cash deductions to take over future years. For this reason, it is much better to inherit real property than to receive it as a gift.

Installment Sale: In many cases, a real estate investor will sell a property and provide financing to the subsequent owner of the property. The subsequent owner will provide a down payment, with additional payments provided over future years. This will typically allow the seller to recognize the sale on an installment basis for tax purposes. Under the installment basis, the investor will recognize the tax due over the installment period. This potentially defers tax payments over a long period of time and alleviates possible liquidity problems that could arise from reporting the entire gain on a sale before receiving all of the sale proceeds.

Increased Tax Deduction Strategies: Rental property affords investors with an opportunity to convert personal expenses to potentially valid business deductions. Rental real estate is a business and as such, business deductions can be used to offset income. Some potential expenses that you would be able to deduct as a real estate investor might be taking the home office deduction, vehicle expenses needed to maintain the properties, and paying family members to manage the properties.

Capital Gains Rate and Recapture: The sale of investments in real property should qualify as a capital transaction. As such, the lower 20% capital gains rate would be paid for federal taxes. Additionally, the recapture of depreciation previously taken by the investor is subject to a 25% tax rate. Both rates are significantly lower than the maximum federal income tax rate of 37%.

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