Tax Strategies for Real Estate Owners

In addition to the appreciation and income generation opportunities it offers, a major benefit of owning rental real estate is the tax advantages available to property owners. This document covers some of the more attractive tax advantages of real estate, including deductions added or expanded by recent legislation.

1031 Exchange

Section 1031 of the IRS code gave birth to what is known as a 1031 exchange, which can be a powerful tool for building real estate equity. It allows a real estate owner to defer taxes on the gain from the sale of a property by purchasing a similar property shortly after the sale. The seller has 45 days after the sale of a property to identify potential replacement properties and then has 180 days from the date of sale to acquire the replacement property. This enables real estate owners to use the full proceeds from the sale to acquire new property and grow their portfolio tax-deferred.

Passive Income and Capital Gains

Real estate owners can benefit from lower taxes while holding and eventually selling a property. Income from a rental property is considered passive and not subject to the 15.3% FICA tax that employers and employees typically pay on wages. Furthermore, when a property is sold, the gain from the sale will be considered a Long-Term Capital Gain instead of ordinary income if the property was held for at least 12 months.

Depreciation

One of the most popular tax breaks for owning rental property is the depreciation deduction. The IRS allows an owner to begin taking deductions for depreciation as soon as their property is placed in service. Residential rental property is depreciated over 27.5 years and commercial rental property is depreciated over 39 years. While you are able to depreciate the cost of the building, you are not able to depreciate the cost of the land. Therefore, it's important to properly value the building and land separately.

100% Bonus Depreciation & Qualified Improvement Property

Under the Tax Cuts and Jobs Act, 100% first-year bonus depreciation is available for qualified assets acquired and placed into service after September 27, 2017. This generally applies to depreciable assets with a recovery period of 20 years or less and enables the owner to expense the full cost of the asset at the time the asset is placed into service.

Qualified Improvement Property is generally defined as any improvement to a commercial building's interior after the building was placed into service. However, it does not include the enlargement of a building, any elevator or escalator or improvements to the internal structural framework of the building. In 2020 the CARES Act assigned a 15-year depreciation to Qualified Improvement Property placed into service after 2017, and thus it qualifies for the 100% first-year bonus depreciation. Also, Qualified Improvement Property placed into service in 2018 or 2019 retroactively qualifies for the bonus depreciation.

Please be aware that the 100% bonus depreciation will begin to phase out in 2023.

Cost Segregation Studies

Real estate owners may benefit from a cost segregation study that breaks down the components of a property into different cost categories, some of which have shorter depreciation schedules of 5, 7, and 15 years. Considering that certain costs with depreciation schedules of 20 years or less qualify for the 100% bonus depreciation, a cost segregation study may provide a real estate owner with significant accelerated tax deductions.

Three Safe Harbors for Real Estate Owners

Real estate owners can benefit from knowing about three safe harbors.

The De Minimis Safe Harbor generally allows an owner to deduct small-dollar expenditures for the acquisition or production of property instead of having to capitalize and depreciate them. This generally applies to invoices that are $2,500 or less.

The Routine Maintenance Safe Harbor allows an owner to expense the cost of repairs that they believe will be repeated at least once every 10 years instead of having to capitalize and depreciate them. Examples of qualifying expenses are carpeting, light fixtures, and parts.

The Safe Harbor for Small Taxpayers enables owners to deduct all annual expenses for repairs, maintenance, improvements, and other costs for a rental building. Certain limits and qualifications are required for this safe harbor.

Qualified Real Estate Professional Status

Income from rental property is classified as passive as opposed to active income. If a taxpayer receives passive tax losses, those losses, with some exceptions, can only be used to offset passive income. However, if an owner qualifies as a real estate professional under the IRS code, then losses generated from the real estate are considered non-passive and can be used to offset ordinary income. This can provide several benefits if a taxpayer or a taxpayer's spouse has significant ordinary income. The tax benefits of accelerated depreciation and 1031 exchanges could result in significant tax losses and thus help in reducing the owner's overall tax liability.

In order to qualify as a real estate professional, an owner doesn't need a real estate license, but there are IRS requirements such as time dedicated to the business that must be satisfied.

Self-Directed IRA

Real estate owners may benefit from purchasing property with funds from a Self-Directed IRA. The IRS allows taxpayers to fund the purchase of property from their IRA, in which case the income and gains are either tax-deferred or tax-free depending on the type of IRA you have. There are certain conditions and limitations, so be sure to consult with our office when considering this type of transaction.

Final Thoughts

This document provides an overview of certain tax benefits for real estate owners. With each one of the benefits, there are many details beyond the scope of this document. As always, we encourage you to speak with one of our associates to discuss tax planning for your specific situation. Feel free to contact our office any time.

About Heard, McElroy & Vestal

In 1946, S. Berton Heard, Charles McElroy and Charles Vestal founded Heard, McElroy & Vestal, LLC in Shreveport, Louisiana. Together, this trio of professionals established the firm as a pillar of trust, integrity and competence, with the mission to create solutions and provide opportunities for our clients, our people, and our communities. HMV is one of the largest public accounting and consulting firms in Northwest Louisiana, servicing our clients throughout the states of Louisiana, Arkansas, Texas, Mississippi, Oklahoma and Tennessee from offices in Shreveport and Monroe. Our firm is comprised of over one hundred (100) employees: Partners, Of Counsel Partners, Senior Managers, Managers, additional Professional Staff and Administrative Staff. Our Professional Staff includes more than fifty (50) certified public accountants who obtain additional certifications which are Accredited in Business Valuation (ABV), Certified Fraud Examiners (CFE), Not-for-Profit Certificate holders, Certified Valuation Analysts (CVA), Personal Financial Specialists (PFS), and Certified Mineral Managers (CMM). Our team of professionals brings together many years and diversification of experience, providing a network of knowledge and resources and allowing for industry and niche specialization. Not one CPA can offer the range and quality of services a firm of our size is able to provide, while remaining small enough to deliver personalized service and attention to our clients with consistency on engagements. HMV's strategic associations include Aliign Mineral Management, LLC, Business Valuation Consultants, LLC and HMV Wealth Advisors, LLC.

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