Your Firm LLC

Tax Benefits of Owning Real Estate

A major benefit of owning real estate is the tax advantages available to property owners. This document covers some of the more attractive tax benefits available to real estate owners.

1031 Exchange

Section 1031 of the IRS code allows a real estate owner to defer taxes on the gain from a property sale by purchasing a similar property shortly after the sale. This enables a real estate owner to use the full proceeds of a sale to reinvest in a new property and defer the taxes on the gains.

Real Estate Business Tax Deductions

The tax code provides opportunities for real estate business owners to receive deductions for many expenses associated with running their business. To qualify for deductibility, expenses must first be ordinary and necessary. Second, they must provide a current vs. a long-term capitalized benefit. Third, they must relate to the operations of the business and real estate. Finally, the amounts must be reasonable. The timing of expenses are important. Expenses that are incurred prior to the "in service" date of the property are typically capitalized and depreciated, whereas expenses after the in-service date are deductible in the current year.

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. It is important to note that 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 value the building and land separately. Certain costs of the building may be depreciated more quickly than the standard 27.5 or 39 years.

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 certain other property.

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.

With that said, the 100% bonus depreciation will begin to phase out in 2023, so current law provides for the 100% cap for the next couple of years.

Cost Segregation Studies

Real estate owners may benefit from a cost segregation study which breaks down a property into different cost categories, some of which have shorter depreciation schedules of 5, 7, and 15 years. When you consider 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 tax deductions immediately.

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 you 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 a building owner to expense repairs that they believe will be repeated at least 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 real estate owners to deduct all annual expenses for repairs, maintenance, improvements, and other costs for a rental building. Certain qualifications are required for this safe harbor.

Qualified Real Estate Professionals Status

Income from rental property is classified as passive income 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 a real estate 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, 1031 exchanges, and cost segregation could result in significant tax losses and thus help in reducing the taxpayer'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 requirements such as time dedicated to the business that must be satisfied.

Next Steps

With each one of the benefits, there are many details beyond the scope of this document. 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 Your Firm LLC

We have hand-picked a team with tax, auditing, accounting, business and management advisory expertise in a multitude of fields, including healthcare, professional-services firms, commercial contractors, home builders, real estate companies, manufacturing and distribution companies, dealerships, non-profit organizations and pension funds.

We have the expertise and the resources to provide not only the critical services you need during these evolving economic times, but also, importantly, to build for the future. Our strategic alliances with professional organizations across the country allow us to bring our clients the talent and expertise of national firms with the high-touch service of a local firm. While we remain focused on the core services of tax, accounting and audit, we expand and offer you the business consulting needed to remain competitive. We believe the success of our clients is the greatest measure of our own.

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