7 Tax-Saving Opportunities for Real Estate Investors

BY DAVID E. GIBBS, CPA, CCIFP, CRE, MBA, McCARTHY & COMPANY

Real estate investors must think about the tax implications of any transaction. Investors can save a substantial amount of money if they implement the right tax-planning strategies. Here are seven recommendations that CPAs should consider for their clients:

1. **Establish a self-directed IRA account.** Holders of a self-directed IRA may fund real estate purchases from their IRA. There is no penalty for being under age 65. The non-financed portion of the purchase is sheltered from taxes by the IRA. A custodian or trust company must administer the self-directed IRA.

2. **Hold properties for more than a year.** Investors who own properties for more than a year are taxed at the capital gains rate instead of their ordinary income tax rate. The capital gains tax rate is 0, 15 or 20 percent, depending on the investor's tax bracket. If the investor lives in the property for at least two years, the first $250,000 of capital gains is tax-free for singles and $500,000 for married couples. Holding property for more than a year also reduces the chance that the IRS will classify the investor as a "dealer," where earnings are generally subject to double FICA taxes because they are considered self-employed.

3. **Defer taxes with a like-kind exchange** IRC Section 1031 allows investors to defer paying taxes on the gain from the sale of a property if the proceeds are reinvested in a similar property. There is no limit on the number of times or frequency of doing a 1031 exchange. Business and investment properties generally qualify.

4. **Qualify as a real estate professional.** Rental activities and income are generally considered passive income unless the investor qualifies as real estate professional for tax purposes. Then it is treated as non-passive income. Losses can be deducted if the real estate professional materially participates in the rental activity — more than 50 percent of the person's time and 750 hours must be spent on real estate activities.

5. **Write off ordinary and necessary business expenses.** Ordinary and necessary business expenses are generally deductible for for-profit entities. The IRS defines an ordinary expense as one that is common and accepted in a trade or business. A necessary expense is one that is helpful and appropriate. An expense does not have to be indispensable to be considered necessary.

6. **Depreciate properties.** The lifespan of a residential building is 27.5 years, according to the IRS. Owners can deduct 1/27.5 of the property's building value each year for the first 27.5 years they own the property. Capital improvements to the property can also be depreciated. However, when the property is sold, the owner may owe taxes for "depreciation recapture" on profits they previously avoided paying taxes on through depreciation. Land cannot be depreciated, nor the costs of clearing, planting or landscaping. Real estate investors who acquired, renovated or built a building should consider a cost segregation study to determine if the property qualifies for accelerated depreciation. Personal property acquired as part of a building may qualify for immediate expensing by claiming 100-percent bonus depreciation under the Tax Cuts and Jobs Act (TCJA).

7. **Take advantage of the 20-percent pass-through deduction.** A provision of the TCJA allows small business owners to deduct 20 percent of domestic qualified business income (QBI) from a pass-through entity. The deduction is taken on the net amount of qualified items of income, gain, deduction and loss with respect to any qualified trade or business of the taxpayer. The deduction cannot exceed taxable income.

There are many other tax elections that real estate investors could consider. It is important for CPAs to look at all transactions before recommending one tax-savings strategy over another. In certain circumstances, taking a deduction may not make sense when considering the tax implications.

David E. Gibbs, CPA, CCIFP, CRE, MBA, is a tax partner with McCarthy & Company, as well as the leader of the firm's real estate niche. He can be reached at david.gibbs@McCarthy.CPA.

LEARN MORE

Sept. 14, Sept. 23, Oct. 5, Oct. 14 or Oct. 26, Live Webcast
REAL ESTATE TAX UPDATE

Sept. 16 or Oct. 11, Live Webcast
REAL ESTATE TAXATION: CRITICAL CONSIDERATIONS

njcpa.org/events