



Why Depreciation is the Best Tax Deduction

WHY DEPRECIATION IS THE BEST TAX DEDUCTION

Many potential real estate investors, and even current investment property owners don't fully understand why depreciation is the best real estate tax deduction of all. Uncle Sam requires property investors to depreciate their investment properties such as rental houses, apartments, warehouses, office buildings and shopping centers. Depreciation is a "paper loss" required for estimated wear, tear and obsolescence. However, land value is not depreciable. Residential income property is depreciated over 27.5 years on a straight-line basis. Commercial property is depreciated over 39 years. Personal property used in operating the property, such as apartment appliances, is depreciated over shorter periods, typically five to 10 years. Even automobiles and trucks used in the investment operations can be depreciated over their useful lives. There is also the new first-year 100 percent deduction for up to \$100,000 of business equipment purchased to consider. Because depreciation is a non-cash expense deduction, it reduces taxable income from the investment property. But it doesn't require any cash outlay, as do property taxes, mortgage interest, utilities, insurance and repairs. Although the depreciation expense deduction often turns a positive cash flow property into a tax loss for income tax purposes, the result is the investor's cash flow from the rental income is said to be "tax sheltered." Because most investment properties appreciate in market value each year, on paper their "book value" is depreciating or declining annually. The bookkeeping result

is the book value declines while the market value usually goes up.

THERE ARE TWO TESTS FOR PASSIVE ACTIVITY LOSS DEDUCTIONS

Real estate investments for tax purposes are said to be a "passive activity." Unless you are a qualified real estate professional entitled to the unlimited realty investment tax loss such as real estate sales commissions, parttime real estate investors who earn less than \$100,000 annually can only claim up to \$25,000 annual passive activity deductions from their other ordinary income. To qualify, part-time investors must pass two tests. First, you must own at least 10 percent of the investment property. The purpose of this tax rule is to eliminate small real estate limited partners from claiming loss deductions against their other ordinary income. Secondly, you must "materially participate" in property management decisions, as explained earlier. To illustrate, if you own a vacation condo that is in a "rental pool" when you aren't using it, then that is not considered material participation because you don't approve each individual who uses your condo.

SAVE UNUSED PASSIVE ACTIVITY DEDUCTIONS FOR FUTURE USE

If you don't qualify to deduct all your investment property passive activity tax losses against ordinary incomes, those undeducted losses can be saved or suspended for use in future tax years or when the property is sold. However, 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 from realty investment assets to offset profits from the sale of the property. The tax result is use of suspended property losses on an aggregate basis, rather than property-by-property.

BEWARE OF RECAPTURED DEPRECIATION WHEN SELLING DEPRECIABLE REALTY

The 1997 Taxpayer Relief Act reduced the federal capital gains tax rate to 20 percent. Then the maximum capital gains tax rate was further reduced to 15 percent in 2003 for assets owned over 12 months. But the special 25 percent depreciation "recaptured" tax rate remains unchanged. "Recapture" means taxed when a property is sold. For example, suppose you bought a small investment property for \$300,000 and deducted \$100,000 of depreciation during your ownership years. That means your book value (also called "adjusted cost basis") declined to \$200,000. Then you sold for \$450,000. Your capital gain is therefore \$250,000 (\$450,000 minus \$200,000). Of that \$250,000 capital gain, the \$100,000 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. However, a superb way to avoid paying the relatively high 25 percent federal recapture tax rate for depreciation deducted is to make a tax-deferred exchange for another investment property, as allowed by Internal Revenue Code 1031.

MATERIAL PARTICIPATION IS REQUIRED FOR INVESTOR TAX BREAKS

If you qualify as a real estate professional who spends at least 750 hours per year, or more than 50 percent of your working time in qualified real estate work, and if you "materially participate" in managing your investment property, there is no limit to the allowable tax deductions from your properties that can be subtracted from your other ordinary income. You can still meet the material participation test and claim the unlimited tax deduction as a real estate professional, even if you hire a professional property manager to operate your property. However, you must make the major decisions such as setting rents, approving major expenses and qualifying new tenants. But day-to-day operating details such as collecting rents, evicting deadbeat tenants and unclogging drains can be delegated to others, such as your resident manager or a professional property manager.

CONCLUSION

Real estate investment property offers many benefits, especially tax shelter and probable appreciation in market value. Ownership tax breaks are available during ownership and at the time of sale or tax-deferred exchange. Full details are available from your tax advisor.