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Tax and Accounting

Tax Benefits

of Real Estate Investing for Real Estate Professionals

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Just how tax-efficient is your business?

As a real estate agent, broker, or investor, you likely have unique tax benefits available to you that simply are not available to people that do not qualify as qualified real estate professionals, as defined by the IRS.

This is not a comprehensive tax guide, but merely a tool to inform you of the 11 ways you can use the benefits of real estate investing to dramatically lower your taxes and create long-term wealth and income.

At Haller Group, PLC, we realize that as Americans we pay over 100 different taxes and fees! We also realize that each person has a finite amount of money they will earn in their lifetime, so we work to eliminate taxes wherever possible. We don't just stop with taxes. Our goal is to help our clients understand their short and long-term financial goals, through proper financial planning, while helping them provide the long-term lifestyle they've always dreamed of.

Thank you.

01

Avoid FICA (Payroll) Tax on Rental Income

Just like dividends and interest income, rental income is not subject to Social Security and Medicare taxes (aka FICA).

If you earn money at a normal salaried job, you pay 7.65% (employee's share) of your salary in FICA taxes. If you're self-employed, you pay 15.3% (employer share/employee share) towards FICA tax.

With a $100,000 salary, that's $7,650 or $15,300 out of pocket from your salary. But if you earn $100,000 in rental income, you avoid the tax completely. This is a massive financial incentive to start earning your long-term income from rental properties!

02

No Tax on Appreciation (aka “Buy & Hold” Like Warren Buffett)

One of the most tax-efficient methods to build wealth is simply not selling. Warren Buffett often says, “my favorite holding period is forever.”

When you sell you pay transaction fees, commissions, and taxes. All of these costs drag down your long-term financial performance because you forever lose the ability for those dollars to compound and grow.

As you know, appreciation of real estate isn’t taxed by the IRS. So, if you buy and hold for many years, it’s possible to let your net worth grow with absolute minimal tax exposure.

When you do choose to sell, real estate has other benefits.

03

Capital Gains Tax at Lower Rates

As of 2018, long-term capital gains tax rates are between 0% to 20%, depending upon your tax bracket. Of course, the shifting political climate can always change these rates. But in general, capital gains tax rates are lower than ordinary income tax rates.

Low capital gains rates are an advantage if you build your long-term investment strategy around strategically selling real estate for growth or living expenses.

For example, one year your deductions and rental depreciation can place you into the second lowest tax bracket. If you happen to sell several properties that year, your long-term capital gain tax rate could be 0%! No kidding!
But even in the higher brackets of 15% or 20%, capital gains tax would be better than the equivalent income tax on ordinary income.

04

Live In Your Flip = No Taxes

What if you want to avoid capital gains tax altogether? Then just buy and immediately move into the house as your principle residence. As long as you live in the home 2 out of the next 5 years, and the home is in the U.S., you can make a tax-free profit of up to $250,000 filing your taxes as single, or $500,000 if you file as married filing jointly.

A real estate strategy called the Live-In Flip takes advantage of this generous tax exemption. Several real estate investors routinely use the live-in flips strategy to build enormous wealth and accelerated their path to early retirement.

Keep in mind that this doesn't have to be a permanent strategy. You could do 2 or 3 flips, reinvest the earnings and move on to other investment strategies.

05

Exchange Properties for Tax-Free Growth

Another way to avoid capital gains tax (and also, depreciation recapture tax) is a Section 1031 tax-free exchange. This technique is named after Section 1031 of the U.S. tax code.

A 1031 exchange allows you to trade one property for another without paying taxes. You must follow specific rules, and you must be classified as an investor, for example, not a dealer who simply flips houses.

Why is this helpful? You get to use 100% of the profits from the sale to reinvest in the next property. This maximizes the growth and compounding of your investments.

For example, let's say you sell a property for $300,000 without a 1031 exchange and pay $35,000 in a capital gain and depreciation recapture taxes. By avoiding these taxes using a 1031 Exchange, you would keep that $35,000 in your pocket and if you reinvested it at 8% return (average market growth rate) for 20 years, you would have over $165,000!

05 continued

The Tax Cut & Jobs Act of 2017 did retain the use of 1031 Tax-Free Exchanges. But there was one negative change for exchangers. Now only real property (the real estate building and land) can be exchanged. Any personal property (appliances, furniture, etc.) can not be exchanged. For large apartment complexes with furnished apartments, this could mean significant taxes paid on a transaction.

06

Opportunity Fund = No Capital Gains Tax!

Qualified Opportunity Funds are a new tax-planning strategy created by the Tax Cuts and Jobs Act tax reform. An Opportunity Fund offers investors a way to defer and reduce capital gains tax liability for both real estate and non-real estate investments – but for a finite amount of time. Sounds great, but it's not quite that easy. I've outlined a scenario below that will help you grasp this new concept better:

To make this as clear as I can (with as few words as possible), I'm going to use this example: On December 1, 2018, you sell $200,000 in stock with a cost basis of $100,000 for a long-term capital gain of $100,000.

Within 180 days, you invest the $100,000 gain in a qualified Opportunity Fund.

You make an election on your 2018 tax return to defer the $100,000 in long-term capital gain income, meaning no taxes on this gain in 2018.

06 continued

On December 31, 2026, your qualified Opportunity Fund has a basis of $15,000 (15 percent of the deferred $100,000 capital gain) since you held it for at least seven years.

Let's assume the fund has a fair market value of $500,000 on December 31, 2026. You'll have a deemed sale on December 31, 2026, and recognize $85,000 in income, computed as follows:

$100,000, which is the lesser of the deferred gain ($100,000) or the fair market value of the fund ($500,000), less
$15,000, the basis in the fund.

On January 1, 2027, your basis in the qualified Opportunity Fund is $100,000 ($15,000 original basis plus $85,000 of deferred gain recognized and taxed in 2026).

If you sell the qualified Opportunity Zone fund in December of 2028 for $1 million, then your basis in the fund is $1 million and you recognize no taxable gain on the sale, since you held it for more than 10 years.

For this strategy to make great financial sense, you need (a) appreciation in your qualified opportunity fund and (b) to hold the investment for at least 10 years so that the appreciation is tax-free to you when you sell your investment.

Opportunity Funds are a great way to build long-term, tax-free wealth. However, you have to play by all of the rules (of which there are many) most of which I have not touched on here.

07

Installment Sales For Income & Deferred Taxes

The IRS gives property investors another tool to reduce taxes on the sale of real estate. This tool is called an installment sale (aka seller financing or seller carry-back mortgage).

Like 1031 exchanges, installment sales are only available to property investors and not to dealers (house flippers). Also, like 1031 exchanges, installment sales allow an investor to defer capital gains tax. But unfortunately, the entire amount of accumulated depreciation must be recaptured at the initial time of sale.

From a practical standpoint, an installment sale just means the seller of an investment property receives the sales price over time. The seller is essentially extending credit to the buyer instead of the buyer getting a bank loan.

For example, a duplex owner could sell you her property for $300,000. $30,000 could be a down payment, and you would still owe $270,000 in the form of a seller financing mortgage. The terms of the financing might be $1,934 per month at 6% for 20 years.

07 continued

This arrangement would be most beneficial if the duplex owner owned the property for a long time and experienced a huge run-up in prices. For example, your duplex owner might have bought the property for $50,000 over 30 years ago.

An installment sale would allow this owner to only pay taxes on the profits received each year. A $250,000 gain at one time would have pushed the seller into higher tax brackets. But the installment sale allows the seller to slowly receive the gains and possibly stay in lower, more favorable tax brackets.

It's also worth mentioning that installment sales can be a great way to transition out of active property management and into a period of more passive income.

08

Borrow Tax-Free Instead of Selling

To raise cash most investors consider selling investments. As I've shown above, this exposes you to taxes or complicated procedures to avoid tax. With real estate, you have another choice. You can simply pull capital out of an investment; tax-free by refinancing. This is exactly what many investors plan to do to help pay for college.

In the end when you need money, most find it better leaning to refinance the properties instead of selling. This has a few benefits, including:

- *You get to keep a well-performing property that you know very well.*
- *You benefit from future loan amortization as your tenants pay it off again.*
- *You benefit from future appreciation of rents and property price.*
- *You pay NO tax on the cash from the refinance because it's borrowed.*

You'd be right to say this technique increases your risk by incurring new debt. But as long as the debt is attractive (fixed interest, low rate, long amortization) and covered conservatively with cash flow and cash reserves, this is a risk many are comfortable with given the benefits.

09

Self-Directed IRA Real Estate Investing

IRAs and 401k style retirement plans are incredible tools to build wealth while minimizing taxes. But most people think of them only as tools to invest in traditional investments like stocks, bonds, mutual funds and REITs. While this is the norm, it's not the rule.

The IRS does not describe what your IRA account can invest in. It only describes what you can NOT invest in. The "do not invest list" includes life insurance and collectibles like artwork, rugs and antiques. Non-traditional investments like real estate, private mortgages, limited partnerships and tax liens are therefore allowed. But more larger retirement account custodians (i.e. Vanguard, Schwab, etc.) do not choose to offer them as a possibility.

So, there is an entire industry of specialized custodians who do allow investments in these non-traditional assets. And while self-directed IRAs are a wonderful tool, there are many pitfalls and strict rules to be careful of. For example, you can't self-deal by loaning money to yourself or to another disqualified person, like a close family member. If you break one of the rules, you could face large penalties and disqualification of your account from tax-free status.

09 continued

One way to invest with your IRA is a loan against real estate. It's lower risk and has fewer moving parts than actually owning the real estate itself. Some people have also purchased local property tax liens, which often pay high interest rates and even sometimes get you a deed to real estate for pennies on the dollar.

10

Die Holding Real Estate
(No Joke!)

This may sound like a joke, but one of the best plans (at least as a tax strategy!) is to die with your real estate. Instead of facing the tax issues of recaptured depreciation or capital gains tax, your heirs instead get a stepped-up basis.

For example, let's say you bought a rental house for $100,000. Forty years later you die and the house is worth $500,000, which means they could sell it for $500,000 and have no capital gains tax to pay.

Keep in mind that inherited assets are still subject to estate taxes. As of this writing (2019) $11.18 million of assets are exempt from any estate taxes. So, your heirs would inherit a lot of property before paying any taxes.

Of course, you don't have to let the tail wag the dog. Tax benefits are only part of the overall equation of finances in life, albeit likely the largest accumulated expense by far. You may have plenty of legitimate reasons (like enjoyment of life!) to pay taxes and spend the money before you die. You could also contribute to a portion of your assets to charity, still pay no taxes, and help decide how worthwhile causes will benefit from your wealth while you're alive.

Depreciation Shelters Income From Tax

The IRS uses depreciation to acknowledge that an asset wears down over time. Somehow the IRS discovered that residential real estate wears down in exactly 27.5 years (sarcasm intended). Other assets have different depreciation timelines.

Unlike other business expenses, depreciation is a paper loss. This means you don't spend any money, yet you still get the expense. This expense can offset taxable income and save money on your annual income tax bill.

Here is a basic example:

Scenario #1 (without depreciation expense):
$5,000 rental income x 24% federal income tax rate
= $1,200 taxes owed

Scenario #2 (with depreciation expense):
$5,000 rental income - $3,000 depreciation expense = $2,000 taxable rental income
$2,000 x 24% federal income tax rate = $480 taxes owed

11 continued

Tax Savings = $1,200 - $480 = $720 (does not include State income tax savings!)

The higher your tax rate, the more taxes you would save in this example. Deprecation is not unique to real estate, but real estate investing uniquely benefits from depreciation. Why? Because the cost of real estate is so large and often purchased with debt.

A $200,000 building (80% of the total cost allocated to the building, 20% to land) depreciated over 27.5 years provides tax shelter of $5,818 per year. If you had 3 rental properties, you'd shelter $17,454 of income from taxes and possibly save $4,189 on your federal income tax return (at a 24% rate)!

There are also other nuances and details related to applying depreciation expenses, but there is no need to go deep and nerd out! Having said that, keep in mind that when the IRS giveth, the IRS can also taketh away.

When you sell a rental property, it's very likely that you'll have to recapture the depreciation and pay taxes on it. The tax rate on this recaptured real estate depreciation is 25%. This creates a big incentive to hold on to real estate, or to use other tax savings strategies when selling, like a 1031 exchange.

You can also potentially pay no capital gains taxes if you purchase property in an Opportunity Zone. I'll discuss 1031 exchanges and Opportunity Zone Funds later in this piece.

**There are nuances in the tax code as to how much you can depreciate. I'll cover those in the next section.*

The Nuances to Depreciation

Prior to the Tax Reform Act of 1986, real estate investors took full advantage of depreciation and real estate losses to shelter other sources of income. This was so popular that many high-earning investors bought real estate simply for its tax advantages.

11 continued

Eventually, President Reagan, Congress and the IRS caught on. So, the rules changed (this is a good lesson to not depend upon beneficial tax rules forever). To summarize the changes, depreciation expense on a rental property was and is still deductible against other passive income. But let's say there is an excess loss. For example, your rental is $3,000, depreciation expense is $5,000, resulting in a $2,000 rental (passive) loss.
Can that $2,000 loss shelter other non-passive income, like your dividends or job income? After the tax reform, usually no.

But there are exceptions:

$25,000 exemption – You can deduct up to $25,000 of passive rental loss against non-passive income if your income (Modified Adjusted Gross Income to be exact) is below $100,000 and you actively participate with your rental.

Real estate professional – You can deduct ALL of the passive rental loss against non-passive income each year if you or a spouse qualify as a "real estate professional," and as a full-time real estate agent/broker, you do!

Year of sale – You can deduct ALL of the passive rental loss (even suspended losses from past years) against non-passive income the year you sell the rental property.

So, you're good for up to $25,000 of deductions if your income is below $100,000 and if you're active with your rental.

You're also very good if you're a real estate professional. But among other things, the rules require you to spend 750 hours or more with your real estate activities.

The third exception means you get to eventually use your passive losses when you sell. These losses can be used to offset depreciation recapture and capital gains from the sale. This is not as good as immediate deductions, but it's a decent consolation.

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