BUCKINGHAM INVESTMENTS
LEARN, PLAN, & INVEST IN REAL ESTATE

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BUCKINGHAM BASICS

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THIS ISSUE: REAL ESTATE INVESTING TAX BENEFITS

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IMPORTANCE OF TAX BENEFITS

Owning investment real estate has many benefits, such as residual income, growing wealth, and pride of ownership but the tax benefits of this asset class are tough to beat. Tax benefits can really accelerate returns in real estate investing. Being aware of these benefits and understanding how they can be implemented is crucial to a successful investing strategy. Here are some of those benefits:

DEDUCTIONS

One of the most common benefits is the ability to write off business expenses against income (generally rental income) generated by real estate investments. Some of the more common deductions include property tax, insurance, interest, management fees, and repairs/maintenance. However, there are additional deductions available when the investment is held in a pass-through entity such as an LLC or LP. The deduction flood gates open with these entities to allow for write offs related to business activities. This includes but is not limited to professional fees such legal and accounting, business equipment such as laptops, office furniture, and some vehicles (Tesla's Model X meets IRS requirements and is popular option for business vehicle deduction), business travel if you and your business partner (or spouse if you are business partners) want to buy rental property in a vacation destination, and meals with prospective/current clients or business partners.

Caution however as certain deductions have limitations such as only 50% of meals are deductible and business vehicles or capital improvements are depreciated over time but may be eligible for bonus/accelerated depreciation.

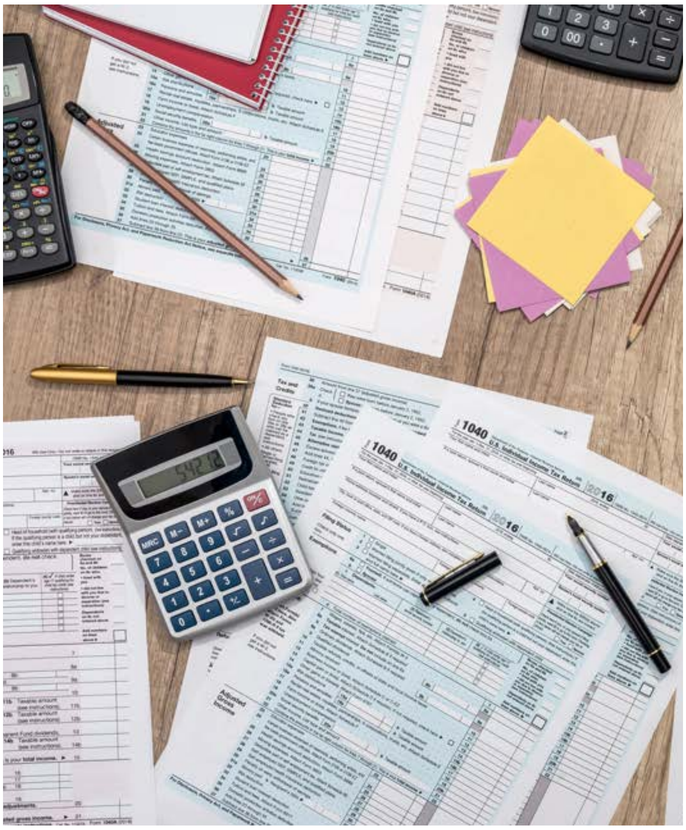
DEPRECIATION

Real property held for business or income-producing purposes for more than one year is eligible for depreciation. This is an accounting method of spreading the cost of an asset over its useful life to better match the revenues it generates with the expense (or cost) of acquiring the said asset. Different asset classes have different useful lives. For instance, commercial property, per the Internal Revenue Code (IRC), has a useful life of 39.5 years while residential rental property has a useful life of 27.5 years. Land is not depreciable per the IRC.

For example, if you were to buy a residential rental property for $575,000 and it was determined that the land was valued at $300,000, you would have a depreciable asset worth $275,000 ($575,000-$300,000). This would allow you to take an additional $10,000 paper expense ($275,000/27.5 years) every year for the next 27.5 years. Paper expense means you get the expense without spending any cash. And if you really consider it, you are likely buying the asset with 75% debt, meaning you are only putting down about $143,000 to get this depreciation expense among other deductions.

Further, this tax break can become significantly higher if you were to use accelerated depreciation.

Unfortunately, not only is the useful life of assets limited, when the asset is sold there, potentially, is a depreciation recapture mechanism that kicks in and could prove to be tax inefficient. A 1031 exchange is used to avoid the depreciation recapture and defer capital gains tax on the disposition or sale of investment property. Our upcoming blog post will go into more detail about how the 1031 exchange works.



CAPITAL GAINS

Capital gains are the profits that arise from selling an asset for more than what you bought it for. They can be classified into short-term capital gains and long-term capital gains for assets held less than 12 months and more than 12 months, respectively. Short-term capital gains are taxed as ordinary income which can be large tax bill depending on your income bracket. However, long-term capital gains are taxed at a maximum of 20% for the highest income earners and as low as 0% for some of the lower income earners.

Capital gains are determined by taking the sale proceeds, which is sale price less any commissions or other selling costs, and subtracting the adjusted cost basis, which is what you paid for the asset plus capital improvements less any depreciation taken (depreciation recapture). By way of example, if you buy a $1,000,000 investment property and spend $100,000 in capital improvements and take $80,000 of depreciation, your adjusted cost basis is $1,020,000 ($1,000,000 + 100,000 - $80,000). You are ready to sell your property after 5 years for $1,400,000 in sale proceeds Your long-term capital gains would be $380,000 ($1,400,000 – 1,020,000). This capital gain would result in a tax liability of $0 - $76,000 depending on your tax bracket. You could use a 1031 exchange to defer the tax liability and depreciation recapture. See our blog post on 1031 exchanges to see how this strategy could help your tax situation.

This was intended to be a brief and basic overview of some of the tax benefits associated with real estate investing. The tax savings illustrated above can be multiplied by combining tax strategies. The items illustrated above are not a comprehensive list. There are other items to consider, such as Qualified Business Income deductions (QBI), use of self-directed retirement accounts, Opportunity Zone investments, Step-up in cost basis, among many other avenues to really use the tax code to your advantage when it comes to real estate investing. Only your tax professional knows your specific financial situation so please consult with them about your unique circumstances.

There are many other benefits of real estate investing outside of the tax realm including appreciation, equity build-up, passive cash-flow, and the ability to leverage. Having your team of experts (including real estate consulting, accounting, legal, property management, etc.) work together is crucial to achieving your goals. Reach out to us at Buckingham Investments to discuss how we can help!

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ABOUT THE AUTHOR

Sam is passionate about generational wealth, passive income, and real estate investing. He helps his clients learn about the benefits of real estate as an asset class, develop a plan to leverage it, and execute on their investing plan to experience truly life changing financial success. He uses his experience in accounting (now an inactive CPA) and his EMBA in finance to help clients navigate the world of investing for a better tomorrow. Reach out to us at Buckingham Investments to discuss how we can help!