

# Tax Benefits of Realty Investments

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By Robert J. Bruss  
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Why do individuals invest in real estate? Appreciation in property market value? Leverage benefits of controlling investment property profits with little or no cash down payments? Income tax shelter benefits?

No matter what type of investment real estate you prefer, such as rental houses, apartments, vacant land, commercial buildings, shopping centers or warehouses, they all offer big tax incentives for investors who understand those benefits.

## 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 operation 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 require.

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 rental income is said to be "tax sheltered." As explained earlier, the investment property tax loss is usually not an actual loss.

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.

## 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 deductions against your ordinary income from other sources, such as real estate sales commissions, part-time realty 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:

1. 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.
2. You must "materially participate" in property management decisions, as explained earlier.

**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.

**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 adviser.

**Real Estate Investment Counseling Inc.**  
**(www.4RentDenver.com)**

**Patrick Chomyn, Rental Agent**

**Cell: (303) 910-1969**

**12000 Zuni St**

**Denver, CO 80234**

**Office: (303) 252-7700**

**Fax: (303) 672-8263**

**[Pat@4rentdenver.com](mailto:Pat@4rentdenver.com)**