

Real estate investing can be taxing

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Q: In one of your columns, you discussed the sale of a commercial property and the recapture of depreciation. In that story you indicated that the repayment of depreciation would be at a rate of 25 percent, but I believe that you should have mentioned that the recapture would be at a maximum rate of 25 percent.

The rate seems to be lower the lower your income. Older folks who have lower incomes, or Schedule E losses they can use, or Schedule D capital losses they can net, may pay a lower rate based on their overall capital gains marginal rate. I point this out because many real estate owners have passive losses that drop their income quite low and they could pay a Depreciation Recapture rate lower than 25 percent.

A: Your point is well taken. The maximum recapture of depreciation rate is 25 percent, but it is tied to income. You also bring up a good point that many people that invest in real estate may have several investments. When you take all of those investments, you might have prior tax years that will affect future years' tax returns and amounts that you might have to pay.

Real estate investing can get quite complicated, especially when it comes to federal income taxes. When we answer questions, we're trying to give an explanation that will be pertinent to the most readers possible.

But given your comment, we thought we'd expand a little on what you touched on.

When you own investment real estate, you (usually) can deduct real estate taxes, insurance expenses, maintenance expenses and other ordinary expenses associated with the ownership of the property. That means if you have \$10,000 of rental income and \$6,000 of expenses, you can reduce the income component that will be taxed by \$6,000.

If you have a mortgage and pay interest on that mortgage, you can deduct the interest expense as well. And, finally, as an investment, you



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can depreciate the building component of the investment over 27.5 years (usually).

This is how things start to get complicated if you are not a full-time investor in real estate. If you only have one or a couple investment properties but are not considered a "real estate investor" under IRS guidelines, you might be limited on the amount of losses you can take on your individual federal income tax return.

Take our example of rental income of \$10,000 with expenses of \$6,000 and, say, interest expenses of \$4,000. If the expenses and the interest equal the income amount, they would offset each other and we wouldn't have any federal income taxes to pay. But let's go further: If the building was purchased for \$300,000 and the building itself was worth \$247,500, we would be entitled to take depreciation

on the building at a rate of \$9,000 per year. And, given our expenses and depreciation, you could say that for IRS purposes we had a \$9,000 loss on that building in that year.

If we have a different building that had a \$9,000 gain, we could offset the gain from the other building with the loss from the first building. This trail of accounting can go on for quite some time and, depending on a person's tax situation, can get complicated by other factors and other taxes imposed on income including the 3.8 percent Net Investment Tax, etc.

If you only hold that one property as an investment, you may be limited on the amount of loss you are entitled to take or may not take a loss at all on your federal income taxes.

And, going back to your comment, if you have significant investments and assets, you might end up having to

repay any depreciation back to the IRS at a rate of 25 percent and if you have losses, or your income has declined or if you have other particular circumstances that affect your federal income taxes, you might end up repaying recapture at a lower rate or not at all if you have overall losses.

All of this is why we suggest that real estate investors (or, those who are thinking about going into this field) should spend some time with a very wise accountant or enrolled agent who can drill down and let you know exactly how these sorts of investments will affect your taxes. Thanks for your comment.

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