

TAX GUIDE

for rental real estate



Many taxpayers find the idea of owning rental property attractive. What could be better than enjoying tax breaks while tenants buy your property for you? Unfortunately, there's a lot more to real estate investing than that. Success takes careful planning and a share of good luck.

The financial rewards from a real estate investment come in three ways: monthly cash flow, tax benefits, and appreciation of the property.

CASH flow

Your cash flow is the difference between the rental income you receive and your total monthly cash outflows, such as mortgage payment, taxes, insurance, and repairs. Some properties show only a small positive cash flow or even a negative cash flow.



In looking at your anticipated cash flow, don't forget to allow for vacancies, when you'll receive no income, or for unexpected repairs, such as a leaking roof or a new furnace. Make sure you have the cash reserves to deal with such situations.

TAX benefits

There are a number of tax benefits to owning rental property. You can "leverage" into a rental property and get tax-deferred appreciation on your investment. You can pull cash out of an appreciated property (through refinancing) without paying tax on the proceeds.

You can trade up to a bigger real estate investment with a tax-deferred exchange. Best of all, these tax benefits are available to the average taxpayer, not just a wealthy few. But before you invest, you should review the basic tax rules on rental real estate.

DEDUCTIBLE expenses

The tax laws allow you to deduct from rental income your rental expenses, such as mortgage interest, property taxes, insurance, and maintenance. You can also deduct depreciation on structures and improvements, but land cannot be depreciated.

Depreciation is a deduction which doesn't require a cash outlay. Deducting depreciation often produces a net tax loss from your rental investment.

RENTAL losses

The tax rules on rental losses are different if you're a real estate professional. But if you're not a professional, here's how your rental loss could affect your income tax. If you actively manage the property and your adjusted gross income does not exceed \$100,000, the rental loss (up to a maximum of \$25,000) could be deducted from other income such as salary, interest, and dividends. The \$25,000 allowable loss phases out between \$100,000 and \$150,000 of adjusted gross income.

If you do not meet the deduction requirements, your net losses are suspended; i.e., held over until a year in which you meet the requirements for deduction, or until you sell the property.

APPRECIATION in value

Historically, a large part of the financial return from real estate has come from appreciation in the value of the property. However, a property may not appreciate, or it may take many years to realize any meaningful appreciation in value. In selecting property, look for undervalued property or property where relatively inexpensive repairs will add significant value.



When you sell your rental property, any profit is a capital gain, taxable like any other capital gain under the tax law. But there's one additional complication: the portion of the gain that represents prior depreciation is subject to special tax rules.

If you sell at a loss, the loss is considered “ordinary,” which means you can deduct the entire amount, rather than being limited by the annual capital loss limitation.

TAX-DEFERRED exchanges

If, instead of selling your property, you exchange it for “like-kind” property in a “tax-deferred” exchange, you can delay the tax until you sell the replacement property. An exchange can be a good way to trade up to a more valuable rental property without creating a tax bill.

Though exchanges require careful planning and professional assistance, they can result in significant tax savings.

MANAGING rental property

Before you invest, don't forget the amount of work it takes to manage rental property. You can hire a management firm, but that will eat into your cash flow and may jeopardize your tax benefits. You can make money by finding the right property in the right location at the right price, choosing the right tenants, and maximizing your tax breaks. But don't underestimate the work involved and the things that can go wrong.



The information in this brochure is general in nature. The tax laws governing rental real estate are extensive and complex. Before you commit to a purchase, sale, or exchange, contact us for a complete financial and tax analysis.

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