The Un-Told Secret Of Real Estate Depreciation

I am constantly amazed with the number of times I scroll through some social media feeds and see someone talking about how they flipped a property, used the BRRRR method, or use their vacation property as short term rental. It seems like everyone who isn’t involved in real estate is missing out on the real estate bonanza. Heck, if the real estate market can collapse between 2008 and 2011 but rebound to new heights a decade later it makes a strong case to become a real estate investor. In fact, when you add up the benefits associated with real estate investing (i.e. cash flow, write-offs, depreciation, and capital appreciation) I am left to wonder why everyone isn’t a real estate investor? That is until I discovered an un-told secret during my investigation into purchasing multi-family units. Once I learned this secret I realized why so many are at a severe disadvantage when investing in real estate. What’s the disadvantage you ask? Well this article is going to pull back the curtain on one of the largest un-told secrets associated with real estate investing; trapped depreciation & losses.

Real Estate Investing 101

To understand the importance of real estate losses we need to take a brief step back and outline the purpose of real estate investing. For those that are well versed in real estate investing you can skip to the next section. For those who are newer to the concept of **real estate investing** the following is an overview of investing in real estate.

Real estate investing is not a new concept. It has been around for hundreds of years. Granted it has taken on newer forms over time but the concept of owning property and leasing /

renting, it to another is not new.

I remember a time when I was in my teens watching Carlton Sheets on late night TV selling the dream of owning real estate. The dream of owning multiple properties that other people would payoff while also paying you a monthly income sounded like a no brainer. Of course, as with everything in life, nothing is ever as simple as it appears.

Assuming you could find a property at an affordable price, a contractor who could complete the necessary repairs in a timely fashion, you had the down payment to purchase and renovate the home, and a renter who would pay the rent on time – the dream of being a real estate investor could be in your future. If everything worked in your favor you could rinse and repeat this process over an over allowing you to build a real estate portfolio that, in some cases, could allow you to become **financially independent** before most of your peers.

Of course, as with anything, there are drawbacks to real estate investing. For example, it isn't feasible to think every property you purchase will be free of damage. It isn't realistic to believe every tenant will be the perfect tenant (e.g. pay on time, never complain, or live in the property for the duration of the time you own it). Furthermore, it is not practical to think items in the property will last longer than projected. It is due to these drawbacks that many investors opt not to invest in real estate. They would rather invest in other areas than be a landlord.

But *IF* you are the lucky one who finds a property with a great tenant that takes care of your property for the duration of the time they live there then you may have hit the jackpot. In situations like this the free cash flow (i.e. total rental income minus all expenses) could offer some financial support in other areas of your life. In fact, if you were able to turn your real estate hobby into a full-time business you could **enjoy an early retirement** depending on the number of properties in your real estate portfolio. Sounds pretty amazing, right?

The Un-Told Secret

Under ideal circumstances real estate investing sounds pretty amazing. In fact, if I didn't love what I do for a living I would absolutely be a full-time real estate investor. Unfortunately, it is for that reason though that I will never be able to receive one of the largest benefits associated with real estate investing, which in many cases makes real estate investing quite lucrative.

Previously I listed a few of the benefits associated with investing in real estate. However, one benefit I left out was related to net losses from depreciation. I left this out because it isn't something everyone benefits from while they own a property. But before we get into that let me explain what depreciation is and how you could benefit from it.

In the most simple terms, depreciation is the deduction – or reduction – of the cost associated with the purchase and renovation of real estate. Essentially it is a paper loss. In other words, to incentivize people to invest in real estate the IRS allows investors to depreciate, or deduct, the value of their real estate over a period of time. This deduction can lower the tax impact of renting the property to someone else. The best part of the deduction – since depreciation is a paper loss, rather than an actual loss from money you spent each year, your total losses each year can exceed your rental income allowing you to apply excess losses to other income (i.e. investment income, wages, profit share distributions, and more).

For example, if you purchase a rental property for $100,000, assuming a normal depreciation schedule, you are allowed to divide $100,000 by 27.5 years and deduct $3,636 of the home's cost basis per year. Add this paper loss to the $10,000 in other expenses associated with owning or maintaining the rental property that year and your $12,000 of rental income is reduced. Heck, it is not just reduced, the $12,000 of taxable income is zeroed out AND you have a loss of $1,636 to carry over. Sounds reasonable, right?

In situations where your rental income far exceeds your allowable deductible losses/expenses you may find yourself in the position of needing to pay income taxes on the excess income. Alternatively, if your expenses exceed your rental income you are not typically required to pay taxes on the income received. This is where depreciation can impact your taxes positively, or negatively. Let me explain.

At different times throughout this article I mentioned the value of being a full-time real estate investor. I did this because this is the ONLY way to deduct ALL of your real estate losses each year. Yes you read that correct… this is the ONLY way to deduct ALL of your real estate losses each year.

But wait Jon… I have been deducting all of my losses and I have been a part time real estate investor for years???

Okay, you caught me… you do not have to be a full-time real estate investor. You can be a part-time real estate investor but frankly you'll probably end up burning out based on the 50-750 rule and the passive activity loss rule. Never heard of those? Let me explain…

50 / 750 Rule

This rule was created by the IRS to draw a bright line in the sand between real estate professionals and everyone else. In IRS Publication 527 to qualify as a real estate professional you must meet the following criteria:

- More than half of the personal services you perform in all trades or businesses during the tax year are performed in real property trades or businesses in which you materially participate.

- You perform more than 750 hours of services during the tax year in real property trades or businesses in which you materially participate.

This means you have to spend at least 50% of your time materially participating in real property trades or business, otherwise you ARE NOT deemed a real estate professional and are not afforded all the perks of one. In other words, if you work a “normal 40 hour work week” – which let’s be honest I can’t remember the last time I worked a 40 hour work week – then you have to ALSO work another 41 hours that same week in real property trades or business. So unless you are already retired, are a workaholic, or are independently wealthy and can devote most of your time to real property trades then you fail the first qualification. If you fail this first test and still deducted depreciation, along with all other rental expenses, then you could be in hot water…

The second qualification is a little easier to meet as it states you need to spend / invest 750 hours a year of your time performing services related to the property you are materially participating in. In other words, if you own a property you need to spend AT LEAST 750 hours per year dedicated to running/managing that property.

For those with multiple properties you can combine the work amongst all properties to reach the 750 hours, instead of needing to perform 750 hours per year per property. But what does materially participating in a property mean?

Well according to the IRS “*you materially participated in an activity for the tax year if you were involved in its operations on a regular, continuous, and substantial basis during the year.*” You can read about this in greater detail in IRS Publication 925.

The cliff notes version of Pub. 925 basically states you need to actively market and manage the property. This would involve things like, but not limited to, advertising the property, fielding calls from tenants, and either doing repairs yourself or hiring others to complete repairs. You are NOT considered to be materially participating in a property if you hire a management company to market a property and field calls from tenants.

But wait, there's hope!!!

If you DO NOT spend 50% of your time working in real estate but DO materially participate in real estate endeavors what happens to the losses your properties accrue, especially if your losses are in EXCESS of your rental income. Have no fear, there is a small loophole…

Passive Activity Loss Rule

There is an exception to the aforementioned 50 / 750 rule but the windfall isn't great. The IRS states "i*f you or your spouse actively participated in a passive rental real estate activity, you may be able to deduct up to $25,000 of loss from the activity from your nonpassive income. This special allowance is an exception to the general rule disallowing losses in excess of income from passive activities.*"

But remember, to be considered actively participating in rental real estate you must perform duties outlined in Pub. 527. In other words…

You actively participated in a rental real estate activity if you (and your spouse) owned at least 10% of the rental property and you made management decisions or arranged for others to provide services (such as repairs) in a significant and bona fide sense. Management decisions that may count as active participation include approving new tenants, deciding on rental terms, approving expenditures, and other similar decisions.

So the good news is even when you do not qualify as a real estate professional you can still deduct a small portion of passive losses against active income (i.e. wages). Unfortunately, any losses in EXCESS OF your $25,000 allowance are trapped until the end of time… well not really. They are trapped for the duration of the time you own the property. Once you sell the property you can unlock those trapped losses.

Conclusion

What's the bottom line you ask? I'll give it to you straight. If you do not spend 50.1% of your working hours on real estate (which would be easy to prove for any employee or full-time non-real estate entrepreneur) AND you do not spend 750 hours materially participating in all of your properties then you CANNOT DEDUCT ALL of your losses. Your passive losses will be limited to your passive income with the exception of $25,000 assuming you actively participate in your rental real estate.

Since depreciation can be such a large expense, depending on your real estate portfolio, you may find yourself in a position where your depreciation is trapped in the property until you sell your property. Therefore, if you find yourself scrolling through some social media feed, or overhear someone talking about not paying taxes because they are a real estate investor, DO NOT fall victim to FOMO (fear of missing out). The benefits afforded to a full-time real estate investor are different than the benefits afforded to everyone else.

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