ABC of real estate investments: The Tax Perspective.

From the desk of Vladimir Turkeltaub, CPA

Every discussion of avoiding extra taxes has two points: 1) Is there a strategy to be used to lower the taxable amount and 2) Will I personally benefit from the strategy. With this perspective I am going to delve right into my main topic: deductions in real estate investment.

Most of the investors choose an LLC (a Limited Liability company) to own a property[1]. Expenses that could be used for tax purposes are exactly the same regardless of the business structure. Those expenses include the ones that are deductible on a yearly basis such as real estate taxes, mortgage interest, insurance, travel, maintenance, cleaning, etc. In other words, everything that you spend currently to run the business.

And there are also expenditures that you deduct over time, during a period of more than a year. The process of expensing of an asset for a period of more than a year is called depreciation. This is a way for an owner to recoup major investments such as the original cost of the building or major remodeling. For example, the cost of a residential building should be deducted over the period of 27.5 years. This period of 27.5 years is called the life of an asset.

Let's assume that you purchased a two-unit property and you started renting it on January 1, 20XX for $275,000. In Year 1 you can deduct $10,000 of the cost of the purchase: $275,000/27.5 = $10,000. The same deduction will continue year after year[2].

Here comes the main point of the story: a Depreciation Study. The Depreciation Study is basically a document that breaks down the above-mentioned rental unit into components: walls, roof, boilers, ranges, water-heaters, A/C units, etc. Then it assigns the percentage of the cost of the total building to each of the components mentioned above and, here comes the most important part, it assigns to different assets different number of years of useful life. It is very logical as you cannot expect your A/C unit to last as long as the roof of your house. Subsequently, you will deduct the cost of your roof over the period of 27.5 years and your A/C over only 10 years[3]. This is not rocket science and is a mandatory project in every master's degree program in the USA.

Thus, the conclusion, instead of deducting only $10,000 in Year 1 you may be able to deduct much more, let's say $25,000. The core question here is: will you benefit from this accelerated deduction? That depends on many factors including your income, short- and long-term goals, the cost of the property and the cost of the Depreciation Study and many other factors. Each case is different and should be analyzed and advised by a tax professional.

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[1] The preferred type of ownership is a very important topic but is beyond the scope of this article. Please consult your tax adviser on the matter.

[2] I am simplifying the process of a yearly deduction for the sake of clarity.

[3] You can even deduct the A/C unit faster. As always please consult your tax adviser.