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Real Estate Tax Advantages

Investment real estate has historically generated income and capital appreciation producing competitive total returns. But did you know that all investment real estate also possesses a "favorable tax status" over most traditional investments, including stocks and most bonds, which can enhance investor's after-tax returns and tax equivalent yields. We explore the many tax benefits of passive real estate investing below.

Depreciation

Investment real estate has a unique depreciation tax shelter. Investors can depreciate the improvements of a physical asset and receive tax benefits (pass through) from depreciation inside a professionally managed real estate fund or REIT while the asset may actually appreciate in value. Current tax laws allow for the depreciation of real estate improvements (excluding land) thereby allowing a significant portion of the value of the real estate asset to be depreciated over time reducing its taxable value. However, investment real estate values are traditionally driven by underlying rents and leases which have historically increased over time and are, in turn, driven by market demand and not the age of a property. The amount of deprecation will vary by investor and situation, but the effect is a reduction in taxable income to investors thereby enhancing yields on a tax equivalent basis.

Non-dividend Distributions

The depreciation benefits of investment real estate can extend beyond direct ownership of a property to also include professionally managed real estate funds and REITs. Using the same process described above, many professionally managed real estate funds or REITs pay cash distributions to investors, all or a portion of which may not be taxable as ordinary income. With the benefit of depreciation, all or a portion of the cash distributions may benefit from a "tax deferral" (the depreciated portion) typically referred to as "non-dividend distributions" which is effectively classified as a return of capital and the tax liability can be deferred to subsequent years when the investment is sold.

Capital Gains vs. Ordinary Income

Due to the non-dividend distributions described above, when the investments in the professionally managed real estate fund/REIT are sold, the deferred tax portion must be paid. Depending on the length of the holding period, the tax liability may be converted to long-term capital gains. Since long-term capital gains tax rates are traditionally lower than most current income tax rates, investors still benefit upon sale as they are likely to have reduced their overall tax liability.

TIP

With effective estate planning, investors can avoid the taxation of non-dividend distributions altogether by passing their real estate investment(s) to their heirs at a "stepped-up" cost basis equal to fair market value of the real estate at the time of death. Beneficiaries therefore, can sell the real estate with no tax consequences on the appreciated value, or continue to hold and receive income.

199A Dividends

Created by the 2017 Tax Cuts and Jobs Act, Section 199A dividends (Qualified Business Income Deductions) include those paid from REITs and professionally managed real estate funds that own REITs (including private REITs) that reduce taxable income through a 20% reduction in the taxes owed on REIT/real estate fund dividends. The real estate component of the deduction equals 20% of the combined qualified REIT dividends (including REIT dividends earned through a regulated investment company (RIC)) and qualified PTP income/(loss). The tax benefits can be reflected in reductions to both ordinary income and capital gains.

Source: https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs

1031 Exchange

Section 1031 of the IRS code is a popular and powerful capital gains tax deferral mechanism. Many real estate investors have benefitted from appreciation in their direct real estate holdings. By following a set of pre-specified IRS rules, these investors may sell their existing real estate while simultaneously investing all or a portion of the capital gains into an exchange property of greater value (a like-kind exchange). This allows individual investors to grow their direct held real estate portfolios while deferring the payment of capital gains taxes and depreciation recapture.

Institutional Real Estate: A Worthy Component of Individual Investment Portfolios

The tax implications of various competitive investments are key in establishing allocations in individual investor portfolios. Investment real estate is one of the few asset classes that can boast attractive income, capital preservation and appreciation, as well as multiple tax benefit opportunities and combined, form a critical investment rationale for the asset class.

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