TAX BENEFITS OF PASSIVE REAL ESTATE INVESTING

As an asset class, real estate is hard to beat, especially as a tax shield. Thanks to the available deductions, it's simpler to shield income from real estate cash flow compared to ordinary earned income. Unlike earned income, which requires FICA deductions, passive income earned from real estate is not subject to FICA and can be sheltered from higher effective tax rates. Additionally, you're able to reap the benefits of depreciation on your property.

For example, you're one of many investors in a $4M multifamily property. As an investor, you'll be able to deduct the property's depreciation from the dividend of your investment. The I.R.S. uses a formula for depreciation in which the value of the property, not including the land it's on, is depreciated over its hypothetical economic life, which under current I.R.S. rules is 27 1/2 years.

You will need to separate the building and improvements from the raw land. Generally, land is not depreciable because it doesn't degrade or need to be replaced. With this formula in mind, we can construct a simple financial statement for this investment property and show the taxable loss as follows.

For a property worth $4 million, not including the land, the annual depreciation would work out to be $145,454 per year over 27.5 years.

Let's take a look at how significantly depreciation can minimize an investor's tax liability. We'll start with the formula for determining a property's ability to cash flow:

Basic Cash Flow Statement Income

(-) Expenses
Net Operating Income
(-) Debt/Mortgage Cash Fow
Cash Flow

With a property of $5 million, including the land, we'll use these projections:

Income $480,000
(-) Expenses -120,000
= Net Operating Income 360,000 (-)
Debt/Mortgage -217,000
= Cash flow 143,000
(-) Depreciation -145,454
= Taxable Loss -2454

You may be wondering about the figures we used. In the above example, the total purchase price is $5,000,000, which is the combined total of the land and the building itself. The building and any rehabbing amounts to $4,000,000 while the land is valued at $1,000,0000. For our revenue, we calculated twenty units renting at $2,000 per month. We utilized a general estimate of property management, taxes, maintenance & vacancy. The mortgage figure assumes a loan of 75% of purchase price, with 4% interest rate & a 30-year term.

As shown above, the property would provide a net cash flow of $143,000 per year. This is basically cash in the bank after expenses and debt payments. Because of the depreciation there is actually a taxable loss on the investment property, which shields it from the higher personal tax rate from earned ordinary income.

Limited Partners Can Claim Depreciation

Even if you're a passive investor and a limited partner, you're still able to reap the benefits of depreciation. Each year, the general partners' accountant creates a Schedule K-1 for the limited partners for each apartment syndicate deal. The passive investors file the K-1 with their tax returns to report their share of the investment's profits, losses, deductions and credits to the IRS, including any depreciation expense that was passed through to them.

To learn more about MC Companies investor program click here.

Always consult your tax and legal adviser prior to making any investments.