



# Tax Advantages Owning Rental Property

William R. Witt, Esq, CPA  
Leslie K. Witt, CPA  
Witt Consulting, Inc.  
Tax Legal Accounting  
582 NW Van Buren Ave.

Corvallis, OR 97330

(541) 758-7100

[bill@wittconsulting.com](mailto:bill@wittconsulting.com)  
[leslie@wittconsulting.com](mailto:leslie@wittconsulting.com)

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## Witt Consulting

Empowering leaders to make informed financial decisions



# Introduction

Come join us and see how we serve clients  
**ALL OVER VIRTUAL AMERICA**



**TAXES • LEGAL • ACCOUNTING • BOOKKEEPING**  
*EMPOWERING YOU TO MAKE INFORMED DECISIONS*



Our founding fathers objected to taxation  
without representation.

They should see it today  
with representation.



# Overview

- What are the KEY advantages?
- When I buy, how I should own?
- If I manage, what do I need to know?
- When I sell, what should I do?
- How to go big?



# Key Tax Advantages to Real Estate

- Less Tax Today
- Tax Exclusion Laws
  - Section 121, 280A(g)
- Tax Deferral Techniques
  - Section 1031



# Pay Later Taxes Not Earlier

## REAL ESTATE

- During ordinary income yrs
  - Very little tax
  - Why? Depreciation
- Time of sale
  - Long-term gain (15-20%)
  - 1250 gain (25%)
- Less tax today with lower rates

## NON REAL ESTATE

- During ordinary income yrs
  - Lots of tax
  - Wages, securities have no depreciation
- Time of sale
  - Long-term gain (15%-20%)
- More tax today with higher rates



# When I Buy, How I Should Own?

- How should my real estate be owned?
  - Personal
  - Trust
  - Corporation



# Case Study

- Mr. A owns a building with a basis of \$400k and a FMV of \$1,000,000.
- Ms. B owns business assets worth \$1,000,000.
- A and B want to form a business that will use assets owned by B and the building owned by A.
- The entity will be owned 50/50 by A and B.
- Should the entity be a Corporation?





# Corporations. Not for Real Estate P1

- A will recognize \$600k in capital gain from receiving stock
  - Since both contribute at the same time then Section 351 allows for exemption.
- Assume debt of \$700k and the corporation takes over the debt, then under 357c, A recognizes \$300k in gain.
- No debt, no problem...until you sell.



# Corporations. Not for Real Estate P2

- Section 362: Corporation sells building
- \$600k corporate cap gain of \$210k
- But what if A wants the remaining \$790k.
- Assume corporation liquidates, then A receives \$390k in gain. (\$790k vs. basis of \$400k) generates \$93k in individual tax
- \$400k gain, costs over \$300k in taxes.



# When I Buy, How I Should Own?

- How should it be owned?

- Personal
- Trust
- Corporation

- LLC

- Much more flexible than the corporate versions
  - Section 721 and 723 are your friends
  - No ownership rules
  - Activity normally gives rise to a change in partner basis



# Managing Properties

- Passive investment
  - Losses are suspended until the property is sold
  - Apply to other passive income
  - Subject to net investment income tax of 3.8%
    - If AGI \$250k (married) \$200k (single)
- Passive loss limitation
  - \$25,000, so long as AGI is less than \$100k
- Real estate professional exception
  - Ordinary income and loss
  - Can exclude income from net investment income



# Real Estate Professional

- Section 469(c)(7)
- Must work
  - More than 50% of his/her time in real estate activities; AND,
  - More than 750 hours in real estate activities.
- A real estate professional must materially participate in *each* rental activity for the loss to be deductible
  - 500 hours per activity
- Group Election
  - Finally Followed Correctly by the IRS
  - April 28, 2014; Chief Counsel Memorandum



# Renting Out the Room

- 14 day rule
- Less than 14 days, no income, but also no expense.
  - Joe and Mary rent out the upstairs of the garage for 5 football games. They collect \$5,000. Non-taxable
- More than 14 days rented, then allocate between personal and renters.



# When I Sell, What Should I Do?

- Recognize
  - Gain
  - Depreciation Recapture
- Section 125 gain exclusion
- § 1031 Tax Deferred Exchange



# Outright Sale

- Long-term gain
  - Normally 15%
  - Income is greater than x then 20%
    - \$406k (single) or \$457k (married)
- Depreciation recapture (1250 gain)
  - Part of the gain is subject to a max of 25%





# Section 121 Exclusion

- \$500k (married), \$250k (single)
- Primary personal residence for 2 years of the last 5 years.
  - Need not be continuous
- New regulations as of August 16, 2014
  - Exceptions to the 2 year rule for unforeseen circumstances gives rise to a reduced exclusion
    - *The occurrence of an event that the taxpayer does not anticipate before purchasing or occupying the residence.*



# Converting Rental Into Personal Residence

- Joe and Mary own a rental house. They move into the rental house as the primary residence. They hold it for 2 years and then sell the house for gain. Can they benefit from the 125 exclusion?
- Partial exclusion
- Still subject to some depreciation recapture



# 1031 Exchange - Definition

- A transaction in which a taxpayer is allowed to exchange one property for another by deferring the tax consequences of the sale.



# Requirements

- Property must be like kind
- Must have the intent to hold (not inventory)
- Property is held for rental, investment, or used in a business
- May invest proceeds from sale of property into 3 or less properties
- Must use a Qualified Intermediary / Accommodator
- Any boot received is gain
- Subject to equal or greater level of debt, or reduction in debt is boot

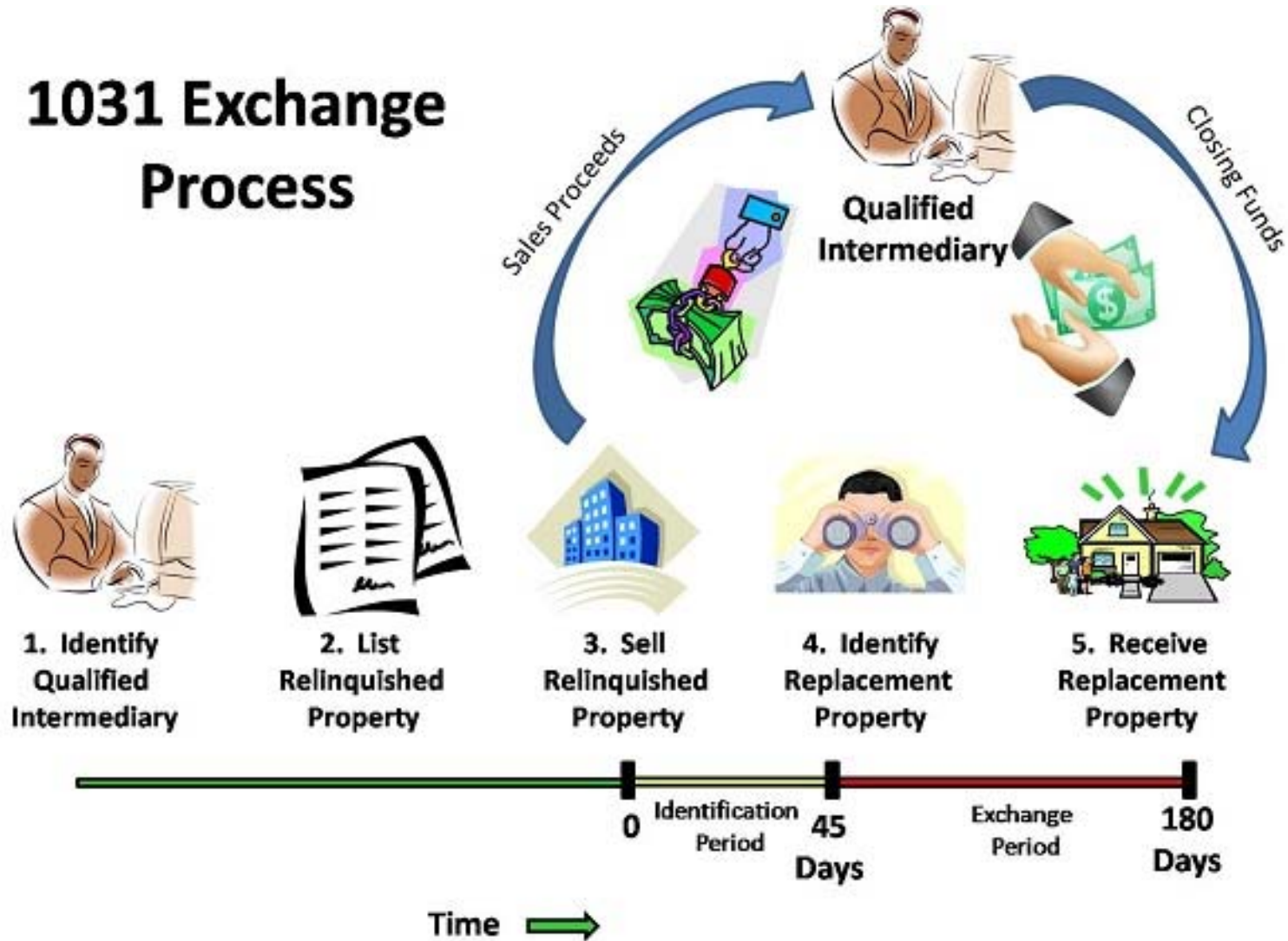


# Excluded from 1031 Treatment

- Personal Residence/Vacation Homes
  - Some exceptions
- Property Acquired for Sale (Inventory)
- Cash, Stocks, Bonds, REITs
- Interests in Partnerships, LLCs, Corporations



# The § 1031 Exchange Process



# § 1031 Exchange Structures



- Forward § 1031 Exchange
  - Sell First
  - Buy Second

- Reverse § 1031 Exchange
  - Purchase First
  - Sell Second



# 1031 – How To Go Big?

- Investor has a pending \$200k capital gain
- No 1031:
  - Incurs a tax liability of approximately \$70k in combined taxes when the property is sold.
  - \$130k remains to reinvest in another property.
  - Assuming a 25% down payment and a 75% LTV ratio, seller would only be able to buy a \$520k new property.
- With a 1031 exchange
  - Investor could reinvest the entire \$200,000 of equity in the purchase of \$800,000 in real estate, assuming the same down payment and loan-to-value ratios.







**Questions**

**Comments**



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