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Real Estate Tax Traps: The Three Biggest Mistakes

Real estate can burden investors -- especially new ones -- with some tricky tax accounting. Here are the three biggest real estate tax traps investors often experience.

1. Passive Loss Limitation

On paper, real estate often loses money. Even if the rent pays the mortgage and the operating expenses, the books still show a loss because you get to write off a portion of the purchase price through depreciation each year.

If a rental house that cost $275,000 breaks even on cash flow, for example, you might also get a $10,000 annual depreciation deduction. If your marginal tax rate is 28%, that depreciation should save you $2,800 annually.

All that sounds good…except that the U.S. Congress labeled real estate investment as a passive activity and that said, except for a couple of special circumstances, you can't write off passive activity deductions unless overall you show positive passive income.

Many times, the passive loss limitation rule causes real estate investors to lose tax savings deductions annually from real estate.

Opportunities exist, however, that let you write off deductions from real estate even if overall you show a loss from real estate investing:

- If you are an active real estate investor with adjusted gross income below $100,000, you can write off up to $25,000 of passive losses annually. If your income is between $100,000 and $150,000, you get to write off a percentage of the $25,000.

- If you are a real estate professional, Congress says the passive loss limitation rule doesn't apply to you. A real estate professional, by the way, is *not* just someone who is a licensed agent or broker. The law instead creates a time-based test: A real estate professional is someone who spends at least 750 hours a year and more than 50% of time working as a real estate agent, broker, property manager or developer.

2. Capitalization of Improvements

Not all costs incurred to improve a property can be written off right away. Sometimes you can, but often you can't.

Here's why: Any expenditure that increases the life of the property or improves its utility needs to be depreciated over the next 27.5 years if the property is residential. You cannot, therefore, write off the money spent to improve or to renovate a house—except through depreciation.

New real estate investors are often in tears over this wrinkle. Suppose an investor draws $20,000 from his IRA or 401(k) to fix up a rental property. He figures he'll be able to write off the $20,000 as a tax deduction in the year improvements are made. Instead, he'll have to write off the $20,000 at the rate of a few hundred dollars a year over the next 27.5 years.

Instead, your strategy should be to keep the property well maintained as you go. Repainting, carpet cleaning, general repairs—these items should all be all deductions in the year of expenditure subject to the passive loss limitation rule.

3. Missing the Section 121 Exclusion

Suppose you decide that instead of selling your principal residence, you are going to turn it into a rental property.

This is a disastrous decision most of the time because of Section 121 of the IRS Code. Section 121 says that if you have owned a home and lived in it for at least 2 of the last years, you won't pay any tax on the first $250,000 of gain on the sale; or $500,000 of gain in the case of someone who's married and filing a joint return.

But by converting a principal residence to a rental property, you turn a tax-free gain into a taxable gain if you don't sell the property in the next 3 years.

Here are options on the Section 121 exclusion:

- If your principal residence has not appreciated, you will not lose any Section 121 benefit by converting it to a rental.

- If you do have a significant appreciation in your principal residence and want to use that equity to acquire a rental property, consider selling the principal residence when you move out so the gain is excluded from taxable income. Then use the tax-free proceeds to purchase another rental.

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