Tax planning for real estate investors

Many individuals invest in real estate to help diversify their portfolio, create an income stream for themselves from rental income and build net worth over time. Often, this is a side activity to a career in another field or running another type of business — not the individual's primary source of income. Holdings might range from a condo or small house you rent out to a multifamily residential building or even a commercial property.

Whatever type of property you own, investment real estate comes with special tax considerations you need to be aware of. With proper planning, you can maximize your after-tax returns.

Rental activity rules

One important consideration is the tax treatment of income and losses from rental properties. They're considered passive by definition — unless you're a real estate professional. Even then, you generally must "materially participate" in a rental activity for it to be treated as nonpassive. Why is this important? Passive income may be subject to the 3.8% net investment income tax (NIIT) on top of any income tax otherwise due, and passive losses are deductible only against passive income, with the excess being carried forward.

For investors who have another primary occupation, qualifying as a real estate professional can be difficult. To qualify, you must annually perform:

- More than 50% of your personal services in real property trades or businesses in which you materially participate, and
- More than 750 hours of service in these businesses during the year.

Each year stands on its own, and there are other nuances to keep in mind.

To materially participate in an activity, generally you must participate more than 500 hours during the year or demonstrate that your involvement constitutes substantially all of the participation in the activity. But there are other ways to meet the material participation test.

Carefully track the time you spend on your real estate activities. If you own rental properties in addition to working in another business or profession, also carefully track the time spent on those non-real-estate activities, so you can see if you spend a small enough portion of your time on them vs. real-estate activities that you can pass the first real estate professional test.

Although your spouse's hours *can't* be counted toward the tests for qualifying as a real estate professional, special rules for spouses may help you meet the material participation test: Generally, your spouse's participation *can* be counted when determining whether you materially participate.

Depreciation breaks

Buying an investment property may be only the beginning of your expenditures. If you renovate or improve a property, the tax treatment of those costs can vary depending on the type of property and improvement. Generally, residential real estate, including improvements, must be depreciated over 27.5 years and commercial real estate over 39 years. But three valuable depreciation-related breaks may be available to real estate investors:

1. Qualified improvement property (QIP) deduction. QIP is defined as an improvement to an interior portion of a nonresidential building placed in service after the building was initially put into use. So these rules can apply to qualifying improvements to commercial real estate, but not to improvements to a residential rental property. QIP has a 15-year Modified Accelerated Cost Recovery System (MACRS) recovery period and qualifies for bonus depreciation and Section 179 expensing.

However, expenditures attributable to the enlargement of a building, elevators or escalators, or the internal structural framework of a building don't count as QIP. They usually must be depreciated over 39 years.

2. Bonus depreciation. This additional first-year depreciation allowance is available for qualified assets, including QIP. Bonus depreciation is 100% for eligible assets acquired and placed in service after January 19, 2025.

3. Section 179 expensing election. This allows you to currently deduct qualified property, subject to certain limits. This includes QIP, certain depreciable tangible personal property used predominantly to furnish lodging and for the following improvements to nonresidential real property: roofs, HVAC equipment, fire protection and alarm systems, and security systems For 2026, the maximum Sec. 179 deduction is $2.56 million. The deduction begins to phase out if the cost of qualifying property placed in service during the year exceeds $4.09 million.

Deferring gains

Eventually, you may decide to sell an appreciated rental or other investment property. You might be able to structure the transaction to defer some or all of the taxable gain. Such strategies may even help you keep your income low enough to avoid triggering the 3.8% NIIT and the 20% long-term capital gains rate.

One example is an installment sale. It allows you to defer gains by spreading them over several years as you receive the proceeds. But ordinary gain from certain depreciation recapture is recognized in the year of sale, even if you receive no cash.

Another option is a Section 1031 exchange. Also known as a “like-kind” exchange, this technique allows you to exchange one real estate investment property for another and defer paying tax on any gain until you sell the replacement property. If you receive cash or other non-like-kind property as part of the exchange, however, you generally must recognize gain to that extent.

These tax deferral strategies aren’t without risks. For example, if tax rates go up, you could ultimately end up paying more in taxes. They also have detailed requirements, so it’s important to consider the tax consequences before completing a sale or exchange.

Tax-smart decisions

Taxes can affect the economics of an investment property from the time you buy it through the time you sell it. Decisions about your involvement in rental activities, improvements to the property, and the timing and structure of a sale can all have tax consequences. Contact us to discuss tax planning related to your investment real estate. We can help you identify potential tax-saving opportunities and avoid tax pitfalls.