IDEAL PROPERTIES IDEAL INVESTMENTS IDEAL MANAGEMENT IDEAL MAINTENANCE

B. Tax Benefit - You're officially a landlord; now, let's look at how it will affect your taxes. The first thing you need to know is all rental activity is considered a 'Passive Activity' and generally speaking a passive loss is not allowed, but with exceptions there are limits to how much you can use passive activity losses to offset other income. There are three basic categories you can fall into, for claiming the loss, of which are outlined, below, with a simple case study:
Let's assume your rental property generates a small positive cash flow after paying all expenses and mortgage payments, but shows a loss after you figure in the 27.5 year straight line depreciation on the structure (FYI - most of the time you can assume the land costs are approximately 20% of the purchase cost, unless the county values show a different ratio):

1. Small investor exception for losses up to $25K - this rule allows losses up to this amount, if your income is $100K or less not counting the rental. This limit is reduced to $0 as your AGI increases from $100K to $150K. Losses from small rental properties are not likely to exceed $25K and as long as your AGI is under $100K you can use this loss each year to save taxes, otherwise the loss is carried over to when the property is sold and you get to claim the loss then.
2. Investors with income over $150K - no passive losses allowed until the activity is sold.
3. Investors who meet the 'Real Estate Professional' rule which says they can use any passive loss at any time, regardless of income level. The definition of such is met when either spouse puts in 750 or more hours in the professions including realtors, mortgage brokers, and builders.

When you sell the property you report a gain, and that gain will be computed using your cost basis reduced by the depreciation you have claimed, including the losses that were carried over to the year of sale. And that's what is called depreciation recapture, meaning the federal rate might be as high as 25% on the depreciation that has been claimed over the years. This means you cannot simply assume all the gain is going to be taxed at the current long term rate of not more than 15%.

These rules can be quite complex and tax regulations are changing all of the time; therefore, you'll find you may need a professional to help you. Please consider having your returns prepared by a professional if you are not in the 60% of families that already do so. Accordingly, we are not providing any tax advice, and encourage you to seek the counsel of tax advisors relative to your ownership of rental properties.