The Real Estate Tax Guide

> Real estate is one of the most tax-advantaged assets there is. Here is how investors use depreciation, exchanges, and structure to keep more.

Real estate is taxed unlike almost any other investment, which is a big part of why investors love it. Depreciation shelters income you actually receive, exchanges defer the tax on gains, and clever structures let you live for less. This guide covers the tax moves that make the numbers work.

Depreciation: a deduction for money you keep

Depreciation is the quiet magic of rental real estate. The IRS lets you deduct the cost of the building, though not the land, over 27.5 years for a residential rental, on the theory that it wears out, even as the property often rises in value. That paper deduction shelters your rental income from tax.

A 400,000 dollar property with 80,000 dollars of land has a 320,000 dollar building, giving about 11,636 dollars of depreciation to deduct every year. That can turn a cash-flow-positive rental into a tax loss on paper. The catch comes at sale, when the depreciation is recaptured and taxed at up to 25 percent, but you deferred that tax for years and deducted at your ordinary rate in the meantime.

The 1031 exchange: deferring the gain

When you sell an investment property, you owe capital gains tax plus depreciation recapture, which can add up fast. A 1031 exchange lets you roll the proceeds into another like-kind property and defer that entire bill, keeping the money working for you.

On a property with a 250,000 dollar gain and 90,000 dollars of depreciation, an exchange can defer roughly 48,780 dollars of tax, the recapture plus the capital gains tax. The rules are strict, with 45 days to identify a replacement and 180 to close, and a qualified intermediary must hold the funds. Done right, investors chain exchanges for decades, and heirs can receive a stepped-up basis that erases the deferred tax entirely.

House hacking: living for less

One of the most tax-efficient ways to start in real estate is to live in the property you invest in. House hacking means buying a home, living in part, and renting out the rest so the rent offsets your mortgage. A 2,800 dollar payment with 2,000 dollars of rent collected leaves a net housing cost of just 800 dollars.

Because you live there, you can buy with an owner-occupant loan and a low down payment, sometimes 3.5 percent, on a building up to four units. The rented portion brings its own deductions and depreciation on that share. It is not passive, since you live near your tenants, but it can nearly eliminate your housing cost while you build equity and learn the business.

Short-term rentals and their rules

Short-term rentals like Airbnb can earn far more than a long-term lease, and they carry their own tax wrinkles. Under certain rules, a short-term rental you materially participate in can be treated more like a business than a passive rental, which changes how losses are used, though the details are technical.

The cash math has to work first. High nightly rates are offset by higher management fees, utilities, supplies, and turnover, so occupancy makes or breaks the return. And local regulations are tightening in many cities, with permits, caps, and lodging taxes that can undermine a property overnight. Model the cash flow and check the local rules before counting on short-term income.

Key takeaway. Depreciation shelters rental income now, a 1031 exchange defers the tax when you sell, and house hacking can wipe out your own housing cost. Real estate rewards investors who understand its tax rules.

Assumptions

- Residential rentals depreciate over 27.5 years, and depreciation recapture is taxed at up to 25 percent. A 1031 exchange defers both the recapture and the capital gains tax.
- These are federal rules with strict requirements. State tax and the details of each transaction vary, so professional guidance is wise.

Sources

- IRS, residential rental property (Pub. 527)
- IRS, like-kind exchanges (Section 1031)