



Tax Deductibility Strategies for Smaller Rental Property Owners

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Agenda

- RKE Company Background
- Real Estate Professional Election
 - Making The Election
 - Requirements
 - Comprehensive Example
- Why Hold Real Estate In an LLC
 - Asset Protection
 - PTET Deduction
- 1031 Exchange Rules
- One Big Beautiful Bill Act Updates





About RKE

- Founded in 2006
- Torrance, CA
- Full Service Public Accounting Firm
 - Tax
 - Assurance
 - Consulting
- 18 Partners
- 120+ professionals

A close-up photograph of a wooden pencil resting on a document with a grid and numbers. The pencil is positioned diagonally across the frame, with its tip pointing towards the bottom right. The document beneath it features a grid pattern and some text, including the words "point is" and "on" visible on the left side. The background is softly blurred, showing more of the document's content.

Real Estate Professional Election – Sec 469(c)(7)



History of Rental Real Estate

- Owning and or investing in real estate has been a well-known strategy to help preserve and accumulate wealth with less chance of economic risk.
- When these properties/investments produce income, the outcome is great. But what happens if these properties produce a loss?
- We know that Sec 469(c)(2) states that all rental activity is passive and therefore when a rental activity is operating at a loss, the passive loss can only offset passive income, or the deduction is otherwise suspended.
- Is there anyway around this limitation? Why do so many taxpayers try to classify themselves as a real estate professional?

Making The Real Estate Professional Election

- Sec 469(c)(7) states that the rental activity of a taxpayer that qualifies as a real estate professional is not presumed to be passive and will be treated as nonpassive if the taxpayer materially participates in the activity.
 - This means that by making the election and filing as a real estate professional, losses from rental real estate activities are no longer deemed to be passive losses but instead are classified as nonpassive losses and can be used to offset other types of income.
- How does a taxpayer make the real estate professional election?

Requirements

Real Estate Professional:

1. More than one half of the personal services the taxpayer performs in trades or business during the year are in real property trades or businesses in which the taxpayer materially participates, and
 2. Hours spend providing personal services in real property trades or business in which the taxpayer materially participates total more than 750 during the tax year.
- A real estate professional taxpayer generally must establish material participation in each rental activity separately; however, a taxpayer may elect to aggregate all his interest in rental real estate for purposes of determining material participation.
 - A safe harbor provides that 500 hours in the rental activity either in the tax year or any of the five years (whether consecutive or not) of the immediately previous 10 years constitutes services in the ordinary course of a trade or business.

Requirements (continued)

Real Estate Professional:

3. Participation is established by any reasonable means.
 - Kept appointment books
 - Calendars
 - Daily Time Reports or logs, etc.



Planning Opportunities

Why do we care if a taxpayer can be classified as a Real Estate Professional? What if we can accelerate losses from a rental real estate property and not have them suspended as passive losses?

Can a spouse be classified as a real estate professional?

Example

Parameters:

\$2,500,000 Residential Rental Real Estate Property

- 75% Building: \$1,875,000
- 25% Land: \$625,000
- Annual depreciation at 27.5 (SL): \$68,181
- Monthly Rental Income: \$3,500 (\$42,000/yr)
- Annual Rental Income/(Loss): (\$38,181)

Without making the Real Estate Professional election, the loss of (\$26,181) would be suspended assuming there is not any passive income. If the election is made, the loss of \$26,181 could be used to offset other types of income such as wages, or business income.

Advanced Tax Planning

As with the previous slide, the more properties you own the more advantageous this real estate professional election becomes. More specifically, if you combine tax planning strategies of a real estate professional election and that of a cost segregation study the benefits become much more beneficial.

\$2,500,000 Residential Rental Real Estate Property

- 75% Building: \$1,875,000
 - 25% of Building Eligible for Bonus Depreciation (at 100%): \$468,750
- 25% Land: \$625,000
- First Year Depreciation: \$51,136 regular SL depreciation and \$468,750 Bonus Depreciation = \$519,886 First Year Depreciation
- Monthly Rental Income: \$3,500 (\$42,000/yr)
- Annual Rental Income/(Loss): (\$477,886)
 - This loss can now be used to offset other types of income, and the loss can be carried forward to future years
 - **Beware of potential NOL and business loss limitations

Assumptions:

- 1) Building purchased for \$10,000,000
- 2) \$2,500,000 allocated to Land / \$7,500,000 allocated to Building (25% land; 75% Building)
- 3) Mid-year convention depreciation
- 4) Based on 2026 Tax Depreciation Rules (Bonus Depreciation 100%)

Asset Life (in years)	Year 1		Year 2		Year 3	
	Pre-Cost Seg	Post - Cost Seg	Pre-Cost Seg	Post - Cost Seg	Pre-Cost Seg	Post - Cost Seg
39	96,154	72,115	192,308	144,231	192,308	144,231
15	-	750,000	-	-	-	-
7	-	375,000	-	-	-	-
5	-	750,000	-	-	-	-
Total Depreciation	96,154	1,947,115	192,308	144,231	192,308	144,231
Cost Seg accelerated depreciation		1,850,962 A		(48,077) A		(48,077) A
Total Accelerated depreciation for yrs 1-3	ΣA	1,754,808				
Estimated Tax Savings for 3 years @ approx 29.6%		519,423				
<i>(Fed rate 37% less 20% QBI = 29.6%)</i>						

Advanced Tax Planning Cont..

<u>Asset life</u>			
<u>Pre cost seg</u>			
39 year life	100%	7,500,000	
<u>Post cost seg</u>			
39 year life	75%	5,625,000	bonus depreciation
15 year	10%	750,000	→ Eligible for bonus 750,000
7 year	5%	375,000	→ Eligible for bonus 375,000
5 year	10%	750,000	→ Eligible for bonus 750,000
Total Basis in Building	100%	7,500,000	1,875,000

Please note : the allocation percentages are based on a general rule of thumb. Each cost segregation study will result in varying percentages of 39, 15, 7, and 5 year property. This illustration is meant for illustration purposes only.

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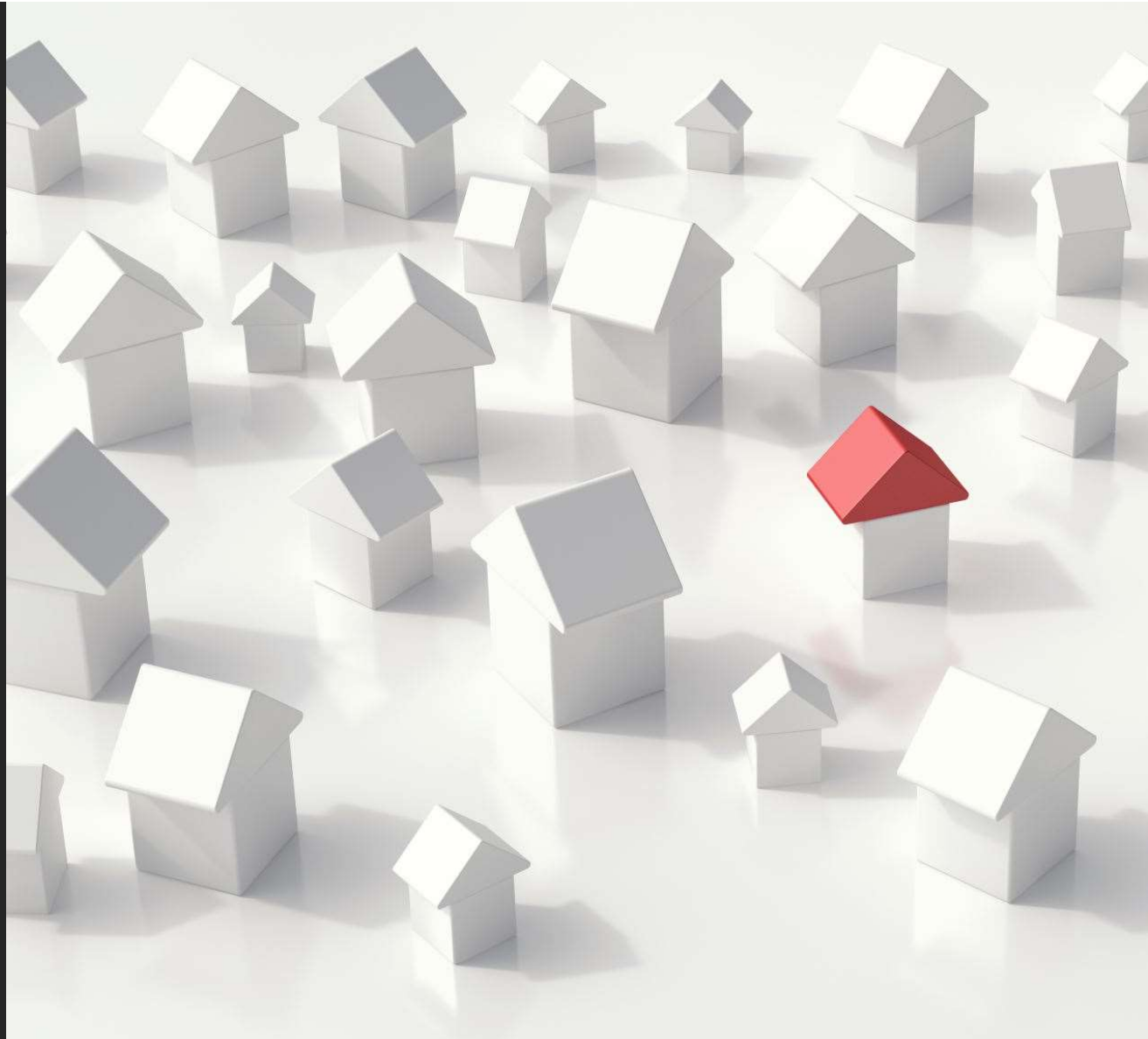


Advanced Tax Planning Summary

- Rental Real Estate is a great way to preserve wealth and unlock many tax advantageous positions.
- By making the real estate professional election, taxpayers are no longer subject to the passive loss rules for the losses associated with said real estate.
- 500 hour safe harbor requirement for election Real Estate Professional.

Why Hold Real Estate In An LLC?

- Asset Protection
- Pass Through Entity Elective Tax (PTET)

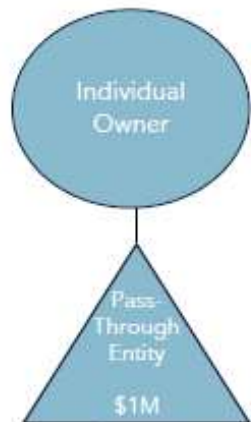




What is the PTET Deduction?

Individuals paying tax in high-tax states, e.g., CA, NY and NJ, were heavily impacted when the 2017 Tax Cuts and Jobs Act (TCJA) limited the state tax deduction for individuals to \$10,000 (\$40,000 with OBBBA with AGI limitation) a year. Since the enactment of TCJA, many state delegations began to lobby for a “work around” this \$10K cap. Many of these “workarounds” entail a state-imposed tax at the pass-through entity level and essentially reduce the federal pass-through income to the individual owners.

How The PTE Election Works



With No PTE Election

- \$1M taxable income passes through to individual owner.
- Assuming individual's federal tax rate is 35% and CA tax rate is 9%, owner pays federal tax of \$350K and California tax of \$90K, or \$440K in total taxes.

With PTE Election

- Pass-Through makes an election and pays \$90K of PTE tax.
- \$910K of federal taxable income and \$1M of CA taxable income pass through to individual owner.
- Owner pays federal tax of \$318,500 and California tax of \$0.
- Total taxes of \$408,500 or a tax savings of \$31,500 with a PTE election

PTET Example



1031 Exchange In Real Estate & Deferral Of Gain Recognition

1031 Exchange Rules

1. Within 45 days of the date the taxpayer transfers the relinquished property, the replacement property is properly identified in a written document signed by the taxpayer and sent to either the person obligated to transfer the replacement property to the taxpayer, or any other person involved in the exchange other than the taxpayer or a disqualified person.
2. The replacement property is received by the earlier of:
 - a. The due date for the filing of its tax return (including extensions) for the tax year of the exchange, or
 - b. 180 days after the date the taxpayer transfers the relinquished property, provided the property is received and it is substantially the same property as the replacement property that was identified.
3. The value of the replacement property is at least equal to the value of the relinquished property.



One Big Beautiful Bill Act Updates

100% Bonus Depreciation is Back!

Qualified Business Income Deduction Made
Permanent

State and Local (SALT) Cap Increase

Reduce Individual Tax Rates Permanency

No Tax on Tips/Overtime Pay

Increase in Standard Deduction

Temporary Deduction for Car Loan Interest



Questions?

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