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Tax Strategies To Help CRE Investors Offset Funding, Demographic Headwinds

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The commercial real estate market is currently in flux, with demographic shifts, supply and demand issues and higher interest rates raising concerns about the health of the market and property valuations. Specifically, the work-from-home trend that emerged during the Covid-19 crisis and the sharp increase in interest rates since 2022 have changed the dynamics of several parts of the CRE market.

However, there are signs of improvements for investors on both the work-from-home and the credit availability fronts. And these issues, some of them short term, should not in any case obscure one of CRE's biggest advantages for investors—the tax benefits. In particular, investors now potentially have the double benefit of getting attractive valuations on new purchases and the tax benefits discussed below.

These tax tactics and strategies can help offset the rising cost of debt, making CRE investments still compelling under many circumstances.

A Turning Of The Tide In CRE Prospects

The news from the CRE markets earlier this year made for dire reading. Nonetheless, the work-from-home trend has begun to reverse, with market leaders Amazon, Google and Meta—not to mention the federal government—requiring staff to return to offices.

In fact, the data company Placer.ai's July 2023 Office Index Recap showed that office traffic across the board increased between 11% and 65%, depending on the month, in 2023 over 2022, though it was admittedly still well below pre-pandemic levels.

CRE Tax Treatment: Potential Ways To Save

In this environment, taking advantage of CRE's favorable tax treatment can make all the difference. Here are several ways CRE investors can potentially lower their tax bills:

Mortgage Interest Deduction

This is particularly attractive for investors worried about rising interest rates. As with residential mortgages, investors can deduct the interest portion of their mortgage payments from their income taxes. This is particularly advantageous in the early years of the mortgage since amortization schedules front-load interest payments.

For example, if you purchased an industrial property for $1 million with a 30-year mortgage at a rate of 6.91% and a 75% loan-to-value ratio, in your first full year you would pay about $51,500 in interest and only $7,886 in principal. In the last year of the mortgage, you would pay about $5,000 in interest and $54,000 in principal.

Term Loan Interest Deduction

Those who have financed a CRE investment not with a traditional amortizing mortgage, but with a term loan, can also deduct the interest payments on the loan. There are three requirements. The investor:

• Must not live on the property.

• Is the person legally responsible for the loan.

• Has agreed with the lender to pay the entire loan and all the interest payments.

Non-Mortgage Tax Deductions

Investors can deduct operating expenses related to the management of the property, including repairs, maintenance costs, management costs and travel and lodging expenses related to managing the investment. However, the value of actual improvements to the property, such as a full-scale renovation, is added to the value of the property and depreciated, per the next section.

Depreciation

Investors can deduct a certain amount from their income taxes to account for depreciation (wear and tear on the property). Owners can depreciate commercial buildings over a 39-year period and residential buildings over a 27.5-year period.

For example, if an investor buys a commercial building for $10 million, they can take roughly $256,000 of depreciation off their taxes each year. Investors can accelerate the depreciation by hiring an engineer to do a cost depreciation study, which determines whether certain parts of the property are wearing out faster than the whole structure—say, the roof or heating systems. In that case, those parts can be depreciated faster, leading to more tax savings.

1031 Exchanges

Investors wishing to change their CRE portfolio holdings can take advantage of a 1031 exchange. This allows them to sell one type of CRE and not pay capital gains on the proceeds if they invest the money in another "like-kind" type of CRE within 180 days, if the new property costs as much or more than the old one.

Deducting Losses On CRE Investments

Investors may be able to deduct losses on CRE investments, depending on what type of investor they are.

• CRE investors making less than $100,000 per year can deduct losses of up to $25,000 on their income taxes.

• Investors making between $100,000 and $150,000 can deduct a lower amount of losses.

• Investors making over $150,000 cannot deduct CRE losses.

• Commercial real estate professionals—including brokers, agents, investors and property managers—who work over 750 hours per year in the field can deduct an unlimited amount of CRE losses.

Opportunity Zones

Investing in properties in Opportunity Zones allows individuals to defer capital gains until Dec. 31, 2026. Opportunity Zones are designed to draw investment into low-income communities. Individuals can invest via Opportunity Funds, which are asset managers that must invest 90% or more of their assets in CRE in one of the over 8,700 designated Qualified Opportunity Zones. If the investor has gotten in early enough to hold the investment for five years prior to 2026, they can take a 10% reduction in his capital gains tax, and if they hold it for seven, they are allowed a further 5% reduction.

As shown above, even if interest rates remain at their current elevated levels, CRE investors have several ways to offset recent headwinds.

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