DON’T LOSE REAL ESTATE TAX DEDUCTIONS ON INVESTMENT PROPERTY

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After the Tax Cuts and Jobs Act became law at the end of 2017, one of its most controversial provisions included capping the state and local tax itemized deduction reported on Schedule A of your Form 1040 at a maximum of $10,000. Many filers for the 2018 tax year exceeded the $10,000 maximum, and did not receive a deduction for all of the state and local income and property taxes paid throughout the year. If you hold investment property in addition to your active farming operations, you do not have to lose your deduction for real estate taxes paid on these properties. There are two viable options to prevent you from losing these deductions.

The first option is to make an annual election with the filing of your tax return to capitalize the real estate taxes paid to the basis in the investment property. This election increases the basis of the investment property by the amount of real estate taxes paid. The benefit to you is a decrease of any future gain on the sale of the property due to the higher basis.

For example, a farmer purchases land for investment purposes in 2018 for $100,000 and paid $3,000 of real estate taxes on this land in 2019. The farmer also incurred $8,000 of state income taxes and $2,000 of real estate taxes on their personal residence in 2019 for a total combined state and local tax expense of $13,000. Of this amount, $3,000 would not be deductible due to the $10,000 limitation and the deduction is “lost” in the phase out. In 2020, the farmer sells the land for $115,000 and reports a capital gain of $15,000. However, if an election was made in 2019 to capitalize the real estate taxes and the land is sold for $115,000, a capital gain of $112,000 would now be recognized on the sale.

From a farmer’s perspective, the first option is a long term strategy as you all don’t sell your property often, if ever. Due to this common position by farmers on selling land, the second option may be more attractive. The second option is to take advantage of a loophole under the TCJA that exempts real estate taxes on investment property from being subject to the $10,000 limitation. The law provides an exception that the $10,000 limitation does not apply to an activity which an individual taxpayer engages in for the production of income or the management, conservation, and maintenance of property held for the production of income. The income does not have to be recurring, and applies to gains from the disposition of the property.

For example, assume the same facts as above regarding the farmer with the land. The farmer purchased this land with the intent of either cash renting or crop sharing it for a profit and holds the land purely as an investment. Under the exception outlined in the TCJA, the farmer will be able to claim the entire $13,000 of state and local taxes incurred in 2019 as part of their itemized deductions.

Both options detailed above will keep farmers who claim itemized deductions from losing the benefit of any real estate taxes paid on their investment properties. It is also worth noting that the first option is available to farmers who do not have enough expenses to claim itemized deductions on their tax return. If you are a farmer claiming the standard deduction, making the election in the first option will also be beneficial to you upon sale of the investment property. Knowing the options available and having these discussions with a tax professional should be done annually to ensure that as a taxpayer you are receiving all the benefits available to you.