Passive Loss Income Limit

I became a landlord this month. We finally gave up trying to sell our last home a couple of months ago and put it up for rent. The renters moved in this month. We're very excited about not eating that cost anymore (at least all of it, it isn't quite cash flow positive yet) but I'm also excited to learn more about rental property investing.

Passive Loss Income Limit

One of the worst parts about real estate investing as a doctor is that you make too much to deduct your passive losses. You can match them up against your passive income, but once that's gone, you have to carry the losses over to another year. After carrying this property for over a year (mortgage, taxes, insurance, HOA fees, utilities, a new roof, windows, maintenance etc) I've got a big fat loss I could really use on my taxes this year. But unfortunately for me (and you too probably), a deduction of up to $25,000 that 5-figure-Joe would have gotten phases out between $100K and $150K in income, and the IRS doesn't care if you're single or married either.

Deducting Interest and Taxes

Since I just barely got it rented, I can claim it as a second home for almost the entire year, which allows me to deduct the interest and taxes for 2011. I also can add on things like the cost of the roof to the basis before I start depreciating the property, which allows for a larger annual depreciation deduction and a higher basis when I eventually sell it. But the loss of that deduction is still a serious downside to investing in rental property as a doc.

Paying Down A Loan is an Investment with a Guaranteed Return

Becoming a landlord also changes some of my savings/investment priorities. The only loan I have on the rental property is a home equity loan which was supposed to be just a bridge loan until I sold it. It didn't cost me much, but the interest rate of 5.35% is certainly higher than the going rate these days (2% higher than my recent refinance on my house.) A guaranteed 5.35% is pretty attractive as an investment these days.

Refinancing and Taking Depreciation

But paying down this loan is a great investment for me for a couple of other reasons. First, I don't have enough equity in it to refinance it. I stripped the equity with the home equity loan to make a down payment on my current residence. So I've only got about a 90% loan to value ratio. That means I need to bring another 10% to the table cash if I want a decent rate on a refinance. Given that it isn't owneroccupied, I can probably only get about 4.25% on a 30 year, and perhaps 3.75% on a 15 year. In retrospect, it would have been better to refinance it while it was still my primary residence. But I never did since I was trying to sell it. So paying down the loan gets me closer to the point where I can refinance and save on the interest.

Second, I’m taking a slight loss each month after paying the mortgage, insurance, management fees, HOA fees, and taxes. Even just considering the interest (the whole mortgage isn’t deductible, just the interest) I can’t fully deduct the depreciation I deserve (about 3.6% of the property’s value per year). Paying down the loan will reduce the interest expense and allow me to fully use the depreciation deduction. Refinancing to a lower rate will not only reduce my interest expenses (and allow for a larger depreciation deduction), but if I refinance into a 30 year (instead of the current 20 year equity loan), it will make the property significantly cash flow positive. And that will put a smile on my face.