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Tax benefits available to Qualified Real Estate Professionals

The tax advantages of being a Qualified Real Estate Professional and why you should care

By Gian Starita

Commercial / Office   Hospitality   Industrial

Are you considered a "Qualified Real Estate Professional" by the IRS? And why should you care?

There are some pretty significant tax benefits that you can take advantage of if you're a "Qualified Real Estate Professional" under IRS guidelines. The most obvious benefit is tax savings if you're a high earner in a state like CA, where your marginal combined rate could hit 54% (37% Fed, 13.3% CA, and an additional 3.8% Medicare tax above a certain Modified Adjusted Gross Income "MAGI" if you're "self employed").

Normally, you can only write off depreciation on real estate against passive income. This includes income from real estate, and certain investments. You normally can't use that write off against active income, like W-2 or other earned wages. These income categories are often at a lower marginal tax rate than ordinary income.

If you are a Qualified Real Estate professional, you can now take that same depreciation expense and apply it against your higher tax bracket income. Now that there is 100% bonus depreciation available, the savings can be significant.

As an example, we recently took a leased medical office Property with +/- 50% debt on it. We then performed a Cost Segregation Study. The net result? Investors in that Property are getting a +/- 50% write off on invested dollars.

Here's the math assuming a 50% marginal tax bracket: We invest $100, and get a $50 write off. That write off saves us $25 in tax obligation this year. Add that to the 6% the property pays from rents, and the effective return is 31% in year 1 (cash flow 6% plus tax savings 25%).

On a sale, you need to be careful or you could have a significant Depreciation Recapture problem. We solve this by using a Delaware Statutory Trust structure. On a sale, each investor can go complete their own 1031 exchange. In other words, unlike an LLC where they are stuck together, they can go buy their own separate property and defer the tax exposure. Maybe forever.

Remember, I am not your attorney, accountant, or priest. Speak with your own professionals before doing anything or relying on something you read on the internet. As always, feel free to call me and pick my brain.
