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The Successful

Real Estate Investors Guide:

TOP TAX TIPS

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Introduction

To make smart investments in real estate, you have to find the right property in the right location, negotiate a great deal, find your financing and manage the closing.

But to be truly successful as a real estate investor, you must consider the tax implications of your purchase:

- Are you a passive investor or active investor?
- Are you investing for long-term capital gains or will your investment result in short-term capital gains?
- Will you take depreciation on your real estate investment?
- How will your real estate investment affect your federal and state income taxes?
- Will you need to set up a partnership, Limited Liability Company (LLC), an S Corporation or purchase properties individually?
- Will your name be on the title to the property you will be purchasing or will a corporation or company hold title to the property?

Savvy investors start thinking about the tax implications of real estate investing before they make a move – and so should you. If you do think about the tax consequences of your purchase, you'll have a greater chance of making a good investment decision and at understanding what that real estate investment can do for you over the long term.

General Tax Benefits of Investing in Real Estate

One of the biggest mistakes a real estate investor can make is to delay thinking about the tax consequences of a purchase.

Ricky Novak, president of Strategic 1031 Exchange Advisors and a real estate attorney, tells his clients to be proactive and start thinking about tax implications at the point they decide to buy a piece of property.

Chet Burges, an enrolled agent who owns Brookwood Tax Service, indicates that "over the long term, real estate has been a very good investment for a lot of people." But being smart about taxes can help turn a good investment into something better.

How should you start thinking about the tax consequences of real estate investments? First, you have to decide what kind of real estate investor you're going to be, while understanding that *active real estate investors* and *passive real estate investors* get treated differently for federal income tax purposes.

Active Real Estate Professionals

If you're an active real estate professional, you make the decisions about buying and selling individual properties and actively manage them. As an active real estate professional, you get to take advantage of various tax benefits and can take tax losses (see below). To qualify as an active real estate professional, you must meet several requirements under the Internal Revenue Code:

1. More than 50 percent of your personal services (work) during the year must be preformed in real property trades or businesses;
2. You must spend more than 750 hours working during the year in real property trades or business (and be able to document it).

"Rental property managers and investors should try to avoid any gray area, because gray areas can cause problems with IRS audits," says Burgess.

Passive Real Estate Investors

If you're a passive real estate investor, you contribute money to the purchase and upkeep of the property, but do not participate in the day-to-day management of the property. As a passive investor you're limited to a deduction of up to $25,000 a year in losses.

If you're an active real estate investor, you need to decide if you're a *flipper* or a *long-term investor*:

Flippers

If you're flipping houses (where you buy and sell houses frequently), the tax code considers you to be "in the business" of renovating and flipping houses. You're going to have to pay more taxes. When you are in the business of buying and selling real estate, you will pay federal income taxes on each sale as ordinary income. That means if you are in the 35 percent tax bracket and you have made $10,000 in profit from the sale of a property, you will pay the federal government $3,500 in income taxes. In addition, you will have other taxes to pay to state and local governments depending on where you live.

There's no magic number or properties you own to become a "flipper." Burgess recommends that if you buy and sell more than one property a year, your houses may be treated like retail inventory and the properties may also be taxed at normal income rates.

Remember, you must hold the property for at least a year or the sale is treated as a short-term capital gain, and you'll be taxed at your normal marginal income rate. But even if you hold the property for one year, if you are in the business of buying and selling real estate, that sale of real estate will probably still be considered "inventory" and taxed at ordinary income tax rates.

Long-Term Investors

Instead of flipping houses, you can renovate a home and sell it or possibly consider using it as a rental property investment for several years. In general, if you hold a property for a year or longer, and upon the sale of that investment property you may qualify under a lower tax classification and be able to consider the profits as capital gains.

That lower tax classification would mean that if you had a $10,000 profit on the sale of the long term investment in real estate and your long-term capital gains rate is 15 percent, you would only pay $1,500 in federal capital gains taxes. Under some scenarios, you might be able to sell the property and defer the payment of all taxes until some date way in the future by using a tax-free deferred exchange, which we will discuss later.

TAX TIP: The $25,000 loss allowance has an income phase out. If your income rises above $100,000 to $150,000, the $25,000 loss allowance phases out gradually. If your adjusted gross income (AGI) is above $150,000, the $25,000 loss allowance is considered "suspended." You must wait until the property is sold or your income drops below $150,000 to claim the losses.

TAX TIP: Active real estate professionals can take losses to the extent they have them on their real estate properties, no matter what their adjusted gross income (AGI). In some

cases these losses are attributable to depreciation taken on their real estate properties and these losses can offset any income they make, reducing the amount they owe in federal income taxes down to zero or close to zero.

Depreciation, Recapture of Depreciation, Maximizing Depreciation

The major tax difference between owning your personal residence and owning investment property is depreciation, or the fixed amount that a rental or investment property owner is allowed to deduct from their federal income taxes each year.

If you buy office supplies for your business, you deduct the cost of those office supplies against the income your business has generated. If the revenue from your business is $10,000 and you have deductible expenses of $7,000, you would pay federal income taxes on about $3,000.

If you buy a building, the federal government allows you to take depreciation on that building over a given period of time, usually 27.5 years for residential rental property. If you purchased a building for $275,000, excluding the value of the land, you could depreciate that building $10,000 each year for 27.5 years.

According to Burgess, depreciation is a tax deduction. But unlike our example of buying office supplies, no actual cash left the pocket of the property owner.

The depreciation that active real estate investors can take is a fixed, deductible cost that reduces the amount of income you would otherwise report to the IRS by sheltering the income the investment property generates.

It has the net effect of reducing the amount you pay in federal income taxes each year. If you have ten properties and each has the same amount of depreciation, you might wind up generating a tremendous amount of cash flow from the properties, but reporting no income to the IRS and paying no federal income taxes.

While this example is quite simplistic, the point is to give you an idea of how depreciation works in real estate and can affect what you pay in federal income taxes.

The total depreciation deduction you take during the years you own the property is *recaptured* (that is, repaid to the IRS) when the property is resold. The reason you take the deduction now is that the money might be worth more to you today than 10 years down the road. And if you use deferral mechanisms upon the sale of investment real estate (such as a 1031 Exchange), you might defer paying real estate taxes for quite some time or even forever.

You might think that taking depreciation is an option, but Novak has seen issues with people renting vacation homes and not taking the appropriate depreciation deduction. "The beach, lake, or mountain house ends up getting treated as a second home and doesn't get depreciated. The IRS could have an issue with the property not being depreciated," says Novak.

Depreciation can be confusing and can be quite complicated, but the IRS has some worksheets that can help you calculate your depreciation. However, the process can still be tedious and cumbersome. Below are some examples from enrolled agent Bill Nemeth on how to handle depreciation.

Depreciation Examples

Simple Example – Depreciation of Residential Real Estate – 27.5 Year Prop

- Each year the property gets depreciated or used up at the rate of 3.636 percent (1/27.5 Years)
- If the depreciable basis of the home is $100,000, the annual depreciation is 3.636 percent of $100,000 or $3,636 per year.
- Depreciation is the item that causes Rental Property to "lose" money each year. (This loss reduces your adjusted gross income and reduces what gets taxed each year by the IRS.)
- After 10 Years, the depreciation will have accumulated to be $36,363.
- If the home is sold after 10 years, the depreciation is "recaptured" by the IRS - $36,363 is added to your income for the year of sale. The rules for depreciation

would require you to pay taxes on the recaptured depreciation at a rate of 25 percent.

Client "Forgot" To Take Depreciation

Clients with self-prepared returns (like those generated by TurboTax) will often "come in to have professional help with their taxes when they get more complicated," according to Nemeth.

"We often see that the client did not take depreciation because they didn't understand depreciation. Unfortunately, they will have to take depreciation into account when they sell because the IRS rules state that "Depreciation, taken or available to be taken, must be factored into the sale," Nemeth explains.

Nemeth says a tax preparer can amend the last three years of federal income tax returns to add depreciation but this may not solve the problem if the client has been omitting depreciation for the last 10 years.

TAX TIP: If you forgot to include depreciation that you should have taken on your federal income tax return, you can amend your federal income taxes and file a Form 3115 to include all the omitted depreciation for the current year return. Once you file the form, you will get all the benefit of the omitted depreciation in that year and may get a big refund, according to Nemeth.

1031 Tax Free Exchanges

If you're going to buy and sell investment real estate, you'll become familiar with Internal Revenue Code Section 1031, which allows for the deferral of capital gains tax on the sale of like-kind property either held for investment or productively used in a trade or business.

For this reason, a Section 1031 Exchange is often referred to as a "Tax-Deferred Exchange" or a "Like-Kind Exchange." Some people will call them Starker Trusts or Starker Exchanges due to the fact that there was a court case by that name that allowed an exchange to be completed and no taxes to be paid to the federal government as a result of the sale of an existing property and the purchase of a replacement property.

A 1031 Exchange not only permits deferral of federal capital gains taxes, it also allows for deferral of depreciation recapture and deferral of state taxes (where applicable). By deferring the taxes associated with the asset sale, the investor is able to preserve his or her equity, and therefore build wealth when reinvesting the preserved equity in future real estate assets.

In short, by using a 1031 Exchange, you can basically sell a real estate investment and use all of the proceeds from that sale to buy another property without having to worry about paying any federal income taxes.

By using a 1031 Exchange every time you sell and purchase a piece of investment real estate, you can build up your real estate portfolio and defer paying federal income taxes until a date in the future when you decide to cash out of your real estate investments.

A 1031 Exchange requires you to hire a *qualified intermediary* (QI)1031 exchange company to act as if it was selling the property and then act on your behalf to purchase a new replacement property.

At the closing of the sale of your existing investment property, the proceeds from the sale go to the QI. You can't receive money directly from the sale of the property. If you receive any cash directly, that money may be taxable to you and reduce the benefit from the 1031 Exchange. In certain instances, where the money that you receive could not go to the 1031 Exchange, you would be entitled to receive those funds.

As an example, if your buyer is crediting you for a reimbursement for work you have done to obtain a tenant or to paint the property and those expenses would not ordinarily go to the 1031 exchange company, you can receive those funds. But the general rule for a closing on an investment property is that you should leave the closing with documents but no cash.

Once you have closed on the sale of the investment property, you will have 45 days to identify the new property you want to buy and 180 days to close on the purchase of this new investment real estate property. (You should know that 1031 exchanges work for all types of property held for investment purposes but for purposes of this eBook, we limit the discussion to real estate investments.)

Novak recommends that if you're going to buy and sell over time, you want to hire a QI company that really understands the nuances of complicated 1031 Exchanges, and is solid and reliable.

According to Novak, the most commonly executed exchange transaction is a Forward Delayed Exchange. With this exchange, property is sold (they usually refer to it as the "Relinquished Property"), and the proceeds are then used to purchase another "like-kind" property (a "Replacement Property"). In order for the exchange to qualify for tax-deferral under the safe harbor regulations, the sale proceeds must be held on behalf of the taxpayer (that would be you, if you have just sold the property) by a QI.

The cost of setting up an exchange trust isn't much, but the benefits of deferring a significant amount of tax to the Federal government can be tremendous. The cost of a 1031 Exchange transaction varies depending on the type of exchange transaction, number of properties involved in the transaction, complexity of the transaction, quality of the QI, and other such variables. In general, a rather vanilla Forward Exchange may cost as little as $750, but more complex exchanges can cost well over $5,000.

TAX TIP: Don't forget that the new property must be a replacement investment property. You cannot sell a strip mall with eight stores and use the funds to purchase your primary residence. For more information on 1031 Tax Deferred Exchanges, see our 1031 Exchange eBook.

Installment Sales and Lease/Options or Lease/Purchase

When you're investing in real estate, you might want to sell the entire property immediately. Instead, you might want to sell it in pieces, over a number of years to spread out the tax liability. If that's the case, you might use an *installment sale* or an installment contract. However, if you wish to rent the property and schedule a sale down the line, you might choose a *lease/option* or *lease/purchase*.

Installment Sales

An installment contract or installment sale (also known as an articles of agreement or articles of agreement for deed) is a form of seller financing where the seller agrees to sell a property to a buyer a little bit at a time. The buyer receives an interest in the house, but the seller holds title to the real estate until the buyer has paid off the installment contract in full.

Essentially, the buyer pays the seller a sum of money as a down payment (which the seller keeps) and must continue to make payments on the installment contract until the full amount is paid. Once the full amount under the installment contract is paid, the seller transfers title to the property to the buyer.

Lease/Options (also known as Lease/Purchases)

A lease purchase allows a seller to rent the property, but collect an option fee upfront from the renter who might want to buy the property down the line.

The option fee is typically a non-refundable fee that gives the buyer the right to purchase the property within 12 months (the time period is negotiable) for a previously agreed-upon price.

Each month, the renter makes his or her rental payment. Sometimes, a portion of the rental amount may be credited toward the buyer's down payment.

The key thing to know about lease/options (also known as lease with an option to buy) is that the seller retains ownership of the property and control. If the buyer does not complete the purchase of the property within the prescribed time period, the buyer may purchase another option with another non-refundable option fee. The seller may agree to leave the purchase price where it is or renegotiate.

Brad Nix, a real estate investor and broker, says he likes to offer a property as a lease-purchase to tenants as an incentive to take care of the property.

"You have more at stake from the tenant. They think they're going to own it eventually. Usually they won't end up going through with the purchase, but it can get them to take care of the property better," says Nix.

Comparing Installment Sales to Lease/Options

Jason Fetrow, with Alliance Property Investments, compares an installment sale to lease/options. He tends to puts his properties up for sale and for lease-purchase simultaneously.

If he sells the property in an installment sale, Fetrow estimates that he usually collects between 1 to 3 percent of the purchase price, but receives all the benefits of an investment property rental, including depreciation and cash flow.

With a lease/option (which Fetrow calls a “rent-to-own”), the seller still owns the property and receives all of the benefits of that ownership while the tenant pays a monthly rental fee. The non-refundable lease/option fee is just more money in the seller’s pocket.

According to Bill Nemeth, there are several scenarios where it makes more sense to offer an installment sale over a lease/option:

1. **The buyer cannot come up with the complete funding to pay for the entire transaction at once.** If the buyer doesn’t have the cash for a down payment or can’t get financing, the seller retains title to the property and allows the buyer to act as if he or she owns the property until the buyer has paid all the amounts owed under the installment contract. Once the buyer has paid all the amounts owed, the seller transfers the title of the property to the buyer.

   The advantage to an installment contract is that the seller retains title to the property. The seller has better control over what the buyer might try to do with the property (including selling it to someone or obtaining additional financing for the property).

   In a default, the seller might have to take legal action against the buyer to kick him out of the property and eliminate any ownership interest he might have accumulated in the property.

2. **Sellers may enjoy lower taxes with an installment sale.** If the seller gets all of the cash from the sale at once, his or her tax bill might be significant. But if the seller sells with an installment sale, the tax bill is spread out over a longer period of time and may ultimately be less. Also, if a seller has a profit on the sale of a real estate investment of $250,000, that profit along with recapture of any depreciation would be significant if paid to the IRS all at once. Under an installment sale, the seller can pay the taxes on the money made from the sale over the time it takes the contract buyer to pay the money back.

TAX TIP: Keep in mind that the long term capital gains tax rate is historically low. If the law changes, and long-term capital gains rates increase, spreading the gain over various years into the future could result in an increase in taxes, rather than getting the benefit from spreading the gain out.

Using Your IRA To Buy Real Estate

According to Burgess, most people do not realize that it is possible to make direct real estate investments in a retirement plan. But you'll need to use a self-directed 401(k) or IRA plan that allows direct investments in real estate. If you live in or otherwise use the real estate, you can't invest in that piece of real estate, says Burgess.

Dos and Don'ts

Burgess has a list of dos and don'ts when it comes to investing in real estate using an IRA or self-directed 401(k):

1. **Make sure all income from the real estate is paid directly into the retirement plan and all expenses are paid directly from the plan assets.** This generally requires a property manager who will remit income to the plan trustee and bill the plan trustee for any expenses.

2. **You, as plan beneficiary, cannot touch any of the money at any time**. You should not sign any real estate documents, including purchase or sales documents – those must be signed by the plan trustee.

3. **You can't use money from a tax-deferred retirement plan to buy a primary residence or vacation home for your personal use.** If you are thinking about turning an investment property into a personal residence down the line, make sure you consult with a good tax advisor.

4. **If you need financing to purchase a property in an IRA or self-directed 401(k), you can't personally guarantee the loan.** You as an individual and the IRA must remain separate entities.

5. **Tax benefits and tax losses from the real estate investments can only flow to the IRA or the self-directed 401(k).** You can't take any of those losses on your personal or business income tax returns. If there is any depreciation to be taken for the property, that depreciation is of little benefit to the IRA or self-directed 401(k), as the funds in the account do not file an annual tax return and there are no profits that can offset the depreciation.

Advantages

In addition to being able to use money that may be tied up in IRA or self-directed 401(k) accounts, some of the advantages in using an IRA or self-directed 401(k), according to Burgess, are as follows:

1. **It's another source of capital for real estate investing.** It doesn't require that you go through a mortgage approval process, which can be onerous.

2. **Cash withdrawn to purchase real estate investments is tax deferred.** Taxes aren't paid when the cash is withdrawn from the IRA or self-directed 401(k) plan as long as you meet the rules for a purchase of investment property. Money withdrawn improperly will be subject to any penalties and taxes.

Disadvantages

However, Burgess noted that some real estate investors can run into trouble by using funds drawn from a self-directed IRA or 401(k):

1. **It's harder to find mortgages for property held in a 401(k) or IRA.** These days, lenders are skittish about anything other than plain vanilla financing (and condo financing can have significant problems). If you're going to use cash from your self-directed IRA or 401(k), you might be best off paying cash for the entire property rather than trying to find a lender who will help.

2. **You lose the potential current tax deductions.** In an IRA, you can't deduct annual losses, period.

3. **The logistics can be cumbersome.** You're dealing with several layers of management, including a trustee and a property manager. These can add expenses and headaches of their own.

4. **Gains will be taxed at ordinary income rather than capital gains rates.** If you're hugely successful, maybe it won't matter. But at the moment, capital gains rates top out at 15 percent, while ordinary income tax rates top out at 35 percent. That's a big difference. If you use cash from a Roth IRA you may not have to worry about this.

TAX TIP: Burgess also notes that the rules for real estate investing within an IRA are very similar to those for a 401(k). One way they differ is that you might be faced with a special tax on what is called *unrelated debt-financed income*. This tax is on that portion of the income attributable to the borrowed portion used to purchase the real estate. You would be well advised to use a qualified tax professional before using an IRA to invest in real estate.

Other Tax Deductions for Real Estate Investors

When you become a real estate investor, you're no longer just filing a simple tax return. Real estate investing opens up more deductions you are allowed to claim on your taxes. Nemeth offers this list of potential deductions a real estate investor can claim:

- Advertising
- Auto and travel associated with rental activities (such as picking up rent check)
- Cleaning and maintenance
- Commissions
- Insurance
- Legal and other professional fees (tax prep, bookkeeping)
- Management fees
- Mortgage interest
- Repairs (not capital improvements, like a new roof)
- Supplies
- Property taxes
- Utilities
- Landscaping activities (mowing lawn, trimming shrubs)
- Community association fees
- Depreciation

According to Burgess, "Many of the expenses that homeowners are used to paying for, but not deducting, are deductible on a rental property." He tells his clients that the deductions go above and beyond the mortgage interest and property tax that they are used to deducting. Rental property owners can deduct the cost of installing and maintaining their security system, waste disposal and pest control.

TAX TIP: If you owe money on a personal loan and an investment loan, which should you pay off first? Interest payments on an investment loan are tax deductible while interest

payments on a personal loan are not. Pay off the personal loan first and maximize your deductions.

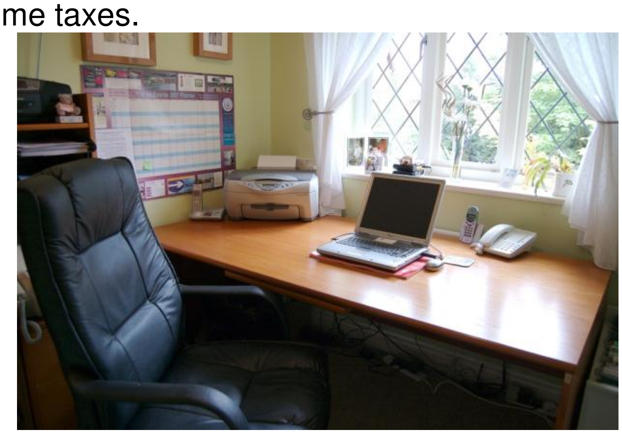
Home Office Tax Deduction

If you're an active real estate investor or full-time real estate professional (which the IRS defines as spending more than 50 percent of your total working hours on real estate sales and management) and you feel confident you can prove that you used a portion of your home exclusively for business purposes, you can get substantial benefits, assuming you file as a self-employed individual on Schedule C.

Active real estate investors might even be able to write off a portion of their own home for the home office deduction.

Nemeth says that if you're an active real estate investor and you use 10 percent of your home to manage your real estate investments, you may be able to take advantage of the following home office deductions:

- Deduction of 10 percent of the cost of insurance on the home.
- Deduction of 10 percent of the property taxes for the home. You might otherwise get to deduct the real estate taxes, but this amount would be taken off the real estate business.
- Deduction of 10 percent of mortgage interest paid on the home mortgage. Again, you might otherwise get to deduct the mortgage interest on your personal side of the federal income tax return, but you would get this portion of the benefit on the business side.
- Deduction of 10 percent of the cost of utilities used in the home.
- Deduction of 10 percent of the amount of the depreciation on the entire home. The amount of this depreciation could be beneficial in terms of reducing the amount you pay in federal income taxes.



The total office-in-home deduction could be a substantial and worthwhile taking for the person that actively manages his real estate investments from an area of his home used exclusively for that purpose.

Keep in mind that a person that uses his home for business purposes will also be entitled to deduct the mileage driven to and from the home of the investment properties as a tax-deductible business expense.

Nemeth recommends using the services of a qualified tax professional for Office-in-Home deductions because he has seen TurboTax lead to incorrect deductions for most novice tax preparers.

Conclusion

If you're serious about investing in real estate, you'll want to think about the tax consequences of your purchase – before you even start looking for properties to buy. Be sure to find a knowledgeable tax preparer who can assist you in making tax-savvy moves.

About Ilyce Glink

Ilyce Glink is the author of ten books, including the bestselling *100 Questions Every First-Time Home Buyer Should Ask*. Her nationally syndicated column, "Real Estate Matters," appears in more than 125 newspapers and Web sites, and her online "Ask Ilyce" columns are read by hundreds of thousands of people every month.

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