11 Powerful Tax Strategies for Real Estate Investors

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Publisher: *ISU*\Information Services Unlimited

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About Al Aiello, CPA, MS Taxation, Real Estate Investor: Al has been a real estate investor for over 25 years. He first got his real estate license and went on to broker millions of dollars of real estate. He then got his CPA by passing the first time; then got his Masters in Taxation graduating with the highest honors in this rigorous program. He was immediately hired as adjunct professor where he taught partnerships, corporations, asset protection and real estate taxation (a course that he suggested, created and developed). With his home study courses, he has thousands of students across the country who uses his strategies to pay little or no taxes, to audit-proof their returns against the IRS and to protect their assets. Al is known to have a character of high integrity; is professional, congenial, and well-liked by seminar participants

11 Powerful Tax Strategies for Real Estate Investors

Albert Aiello, CPA, MS Taxation, RE Investor

Real estate is one of the safest and quickest ways to build wealth. It also yields the best tax-saving opportunities to accelerate your wealth building even further. Unfortunately most real estate investors (and CPA's) are not aware of these golden opportunities.

And remember what Supreme Court Justice, Learned Hand said...

> *"Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes"*

So let's go for it! Here is a checklist of some of the more important strategies you can do to save taxes and thus increase your wealth as a real estate investor1. This checklist will then be followed by a more in-depth discussion:

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1. <u>UNDERSTAND THAT SAVING TAXES ACCELERATES WEATLH</u>: Know why saving taxes makes you wealthy and is well worth the effort. In my tax presentations one of the first things I cover is why and how saving taxes can make you richer, faster. Well, here it is...

If you take $1.00 and double it tax-free for 20 days it's worth $1,048,576 (over a million dollars). Take that that same $1.00, taxed every year at 30%, it will be worth only about $40,640 -- A LOSS of a MILLION DOLLARS! Why is this so? Because with *tax-free* compounding, earnings accumulate not only on the principal amount of money but *also* accumulate on the *tax-free* earnings as well. ("*Earnings on Earnings*"). Thus compounding *combines* earning power on principal *and* earning power on interest. Compounding has been called the "8th wonder of the world", a "miracle". Compounding money at high rates of *tax-free* return is a definite advantage of real estate, especially with a great tax plan.

The wealthy know that taxes are a primary factor in determining whether you get rich or stay poor. Let's say, for example, you're able to save just $2,000 annually on your tax bill. (With a good tax plan it will be much higher). You invest the $2,000 annually in an IRA which earns a tax-free annual return of 10%. After 20 years, you'll have over $114,000! If you can save $10,000 annually on your tax bill and invest it in a Simple IRA for 20 years, you'll end up with almost $573,000!

$5,000 in tax savings (<u>which is found money</u>) as a 10% down payment can allow you to buy <u>an additional</u> $50,000 in real estate! Assuming a 20% yearly return you would earn $10,000 which in 5 years would accumulate t to $50,000!

You can use the tax savings to upgrade your rental properties for more monthly cash flow. One of my students, Richard, used $2,000 of tax savings (like found money) to employ the Mr. Landlord technique of adding optional upgrades to his facilities and increased his cash flow by $200 a month or a yearly total of $2400 which divided by $2000 = 120% return! **But because the $2,000 in tax savings is found money, the return is really infinite!!**

So does *Saving Taxes Makes You Wealthy*? – What would you say now?

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2. <u>SELECT THE RIGHT ENTITY</u>: Start off with right form of ownership entity. Do this not only to protect you, but also to support tax deductions that typically would be more aggressive if taken as a sole proprietor. With an entity, such as an LLC, you can use corporate-like documents (such as an operating agreement, minutes or resolutions) to authorize and thus support deductions. Here, you have this statutory LLC entity (separate from its members), via legal documents (such as an operating agreement), authorizing tax saving deductions and strategies. This is excellent documentation, especially with IRS hot spots such as active participation for bypassing passive loss limitations; avoiding dealer status, as well as deductions such as auto, meals, entertainment; travel to find property; educational tuitions for boot camps; travel to such educational events; and the like.

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3. <u>AVOID IRS</u>: Employ "Audit-Proofing" Techniques To Be Free of The Worry & Costs of IRS Intervention. There are over 30 ways to audit proof your return against the IRS. Here are two powerful ways:

(a) File an extension for your tax return. File as late as legally possible, with typically is October 15 following the tax year. Because of the IRS computer's "first come, first serve" system, returns filed early are more

prone to audit. To file extensions, use IRS Forms 4868 for individuals and 7004 for entities such as LLC's and partnerships. Understand, that filing an extension does not postpone the payment of any taxes you owe. This is not its purpose. The purpose is to reduce your chances of an audit, stop the April 15th mad rush and numerous other advantages.

(b) Attach written explanations to your return, for items that you believe unusual or audit prone. Include the appropriate tax law citations with these explanations. For example for high travel and entertainment deductions you can attach this audit-proofing statement: *Auto, entertainment and travel deductions are necessary for my business and are done in strict accordance with the substantiation requirements of IRS regulation 1.274-5T(c), including maintaining written account books with date, place, persons, amounts and business purpose. Also on file are related bills and receipts as well as notarized statements explaining and attesting to the business use and purpose of these items.*

Sign and notarize the statement. This will help keep you out of the audit pile.

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4. <u>AVOID INEPT CPA'S</u>: Fire-Up, or Fire Your Tax Advisor. One of the biggest reasons why real estate investors (and others) pay too many taxes is <u>bad advice</u> from inept or overly conservative tax advisors. An article in *Money Magazine* revealed that 50 different tax preparers were given the same family's financial records. *The Result*: <u>50</u> <u>different</u> answers as to what the family's taxes should be. And we are talking about *significant* differences as high as 54%, plus the amount of taxes due varied by *thousands* of dollars. Most erred in favor of the IRS! Money Magazine also did an article titled, *"Whose Side Is Your Tax Preparer On?"* In many cases, it's *not* your side! Unlike doctors, accountants are not formally categorized into various specialties, such as a *"Tax Specialist"* or a *"Real Estate Tax Specialist"* .

Here are some suggested questions of a prospective tax advisor:

How much is 2 + 2? If they say "4", don't hire them. However if they say, "*What would you like it to be!*"...Then this may be the one to hire. That is, you do not want someone who is overly conservative. A conservative tax advisor is like a slow race horse -- worthless! On the other hand, you do not want the tax advisor to be reckless, blundering, and imprudent. Remember the overall objective is to *both* maximize tax savings and minimize IRS problems.

Could you tell me about a recent tax change about real estate that may interest me? This will tell you how sharp and updated the person is about taxes affecting real estate.

Will you help me plan my taxes to ensure the best possible outcome under different scenarios? You do not just want a "bean counter" or "glorified bookkeeper" to simply put numbers on a form. You want someone not only to prepare your return, but also to *plan* it. Expect to pay more for this. However, the additional investment could save you significantly.

What steps do you take to reduce the chances of my return being audited? This is an excellent test of their knowledge and willingness to be diligent and concerned about your tax situation.

Can you provide references from real estate investor clients as to your quality of service? **When you are checking with the reference ask specifically, why they like the tax advisor. For example, *Did they come up with tax-saving ideas that others did not think of? Were they very thorough by explaining your tax situation? Did they call you during the***

year to make tax-reduction suggestions? "Would you recommend them to your mother?"

If the reason why they like them is too general or more personal than business, this may not be a good referral source.

You want a tax advisor who can: (1) Assist you in rethinking your tax situation under current laws, especially those affecting real estate, (2) Apprise you of tax-reduction opportunities (old & new), (3) Alert you to IRS "tax traps", (4) Give you prompt, courteous service and (5) Be ethical. If you believe that your tax advisor basically has what it takes, have a candid discussion with them and see if you can help provide any missing links. If after your discussion, the tax advisor is not open to new ideas, then stop the bleeding and *immediately* get rid of them!

One thing is for sure, like a bad tenant...<u>having NO tax advisor is a heavenly dream next to having a bad one</u>.

Also, <u>do not limit yourself to just someone "local"</u>. With today's technology we are closer to each other than ever before, despite being many miles way. <u>Don't let physical distance get in the way of money-saving advice</u>.

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5. DO NOT OVERTAX RENT INCOME: While it is Ordinary Income, Rent Income is Not Subject to Social Security taxes. That is, rents for the use of property are *not* subject to self-employment (social security) taxes. IRC 1402 (a)(1). This is so regardless of the number of rentals that are owned.

<u>ALERT</u>: I have seen numerous times - CPA's erroneously classify rent income for the use of property as self employment (social security) income - causing the investor to pay about another 15% of the income in taxes. Ouch!

For seven years this happened to one of my students with their self-storage facilities. When they realized the CPA's blunder, they could only go back three years to amend the return to recoup the past paid taxes. It was too late for the prior four years of $10,000 in taxes!

NOTE: There are many deductions that can substantially lower rent income and even create a "paper" tax loss; see next.

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6. CREATE VALUABLE DEPRECIATION DEDUCTIONS: Substantially Increase Depreciation Deductions Via Componentizing (Cost Segregation Analysis). Depreciation is your most valuable deduction because it does not require you to expend cash to get the deduction, yet it creates cash flow in your pocket from the deduction's tax savings. For example, a $20,000 depreciation deduction reduces your ordinary income. In a 30% bracket this will save you $6,000 in taxes. This is like found money because you did not have to spend any additional cash to get the deduction. The $6,000 as a 10% down payment can allow you to buy an additional $60,000 worth of real estate, which, at a 20% yearly return, would be $12,000 more income every year. Plus, like money in the bank, you get the deduction and tax savings every year (for the recovery period of the property). Yet, when you sell, you can have no recapture and thus not have to pay any of these tax savings back by selling the property, tax free, via the powerful 1031 exchange (covered later). You still continue to pocket the tax savings from depreciation. Money makes money; but saving taxes (every year) makes a whole lot more money so you can get wealthier, quicker!

So how can you make this already valuable deduction save you even more? *Componentize*!

Componentizing (or *Cost Segregation Analysis*) is something that I have been using for over 25 years to dramatically increase my cash flow (and

wealth) via tax savings from much larger depreciation deductions. Many of my students also use it with the same money-saving results.

Reason: With componentizing, you break out components, from the property cost, that allow you to use shorter recovery periods with the result of much larger deductions and savings. An overview of these components and strategies follow:

5-Year personal property -- Included in the cost of your property are many items of "hidden" personal property that can be written off over 5 years, using a faster accelerated method, instead of 27-1/2 or 39 years, using a slower straight-line method. Typically, the amount of personal property will be at least 10 to 20% of the cost of a rental property. Some Examples: Kitchen cabinets, shelves, storage, carpeting, appliances, movable wall partitions, including "non-weight" bearing interior walls. One of my students, Ron, installed $80,000 of non-weight bearing movable walls in his commercial property. *Result*: Because the walls can be moved without adversely affecting the building structure, they are considered personal property and can be depreciated over 5 years (accelerated) instead of 39 years (slower) straight-line. This equates to a $16,000 a year deduction vs. $2,000. Tax savings of over $5,000 for five years! (Plus Ron expanded his rental market with the movable walls giving his tenants more options as to office space). There are many other items of such personal property fully supported by tax law citations.

15-year land improvements to the land -- Also included in the cost of your property are many items of land improvements that can be written off over 15 years, using a faster accelerated method, instead of not being depreciated at all if they were part of the land. Some examples are landscaping, paved surfaces, and parking lots.

Land improvements to the building -- These are depreciated along with the building (27-1/2 or 39years), instead of not being depreciated at all if they were part of the land. Some examples are outside lighting and utility connections to the building.

A low land value maximizes depreciation deductions -- The land portion of the cost of the property is not eligible for depreciation deductions. The less of the property cost allocated toward non-depreciation land, the more toward the other depreciable components, the more non-cash deductions, the more savings. Don't be talked into using a high land value! You can justify a very low (or no) non-depreciable land value if you know the rules. Keep the following in mind - Allocations toward depreciable land improvements reduce the amount allocated to non-depreciable land. Special valuation factors have also worked to the taxpayer's advantage in lowering the value of land (such as housing shortages).

Fully deduct the remaining basis of components that are replaced (gut out). For example, in doing a rehab, if you replace existing property components with a remaining componentized cost basis of $30,000, you can claim the entire $30,000 as a full ordinary deduction. In a 30% bracket this <u>puts $9,000 of savings in your pocket, yet you did not have to expend cash for the deduction!</u>

So how much extra did you pay in taxes <u>not</u> using componentizing because your tax advisor did not know about this incredible legal strategy? According to the follow quote from one of my students, probably a lot!

> *"Al, your component depreciation method saved me almost $20,000 dollars in income taxes. It helped me financially having four girls in College at the same time."* ...Angelo D. Guerra, Investor, Broker/Owner, ERA Platinum Realtors, Conshohocken, PA.

By the way, that's $20,000 a year, which if invested at 10% a year for the next 10 years would accumulate to over $318,000! That's how much you lose!!

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7. <u>GENERATE REPAIR DEDUCTIONS</u>: Employ Strategies To Reclassify Rehab Improvements Into Fully Deductible Repairs. There are three major tax-saving benefits of classifying expenditures as repairs rather than capital improvements. One of them is *immediate* tax savings. For example, the owner of a rental property is in a 31% tax bracket and pays $20,000 as a repair is an *immediate* deduction which is worth $6,200 in tax savings. But if the $20,000 is capital "punishment" it must be written off over 27-1/2 years = an annual deduction of about $720 year = tax savings of only about $200 in the first year. A difference in *immediate* tax savings of $6,000! These tax savings could be used as an immediate source of down payment monies for other income-producing real estate.

There are over 20 tax saving ideas to convert capital improvements into fully deductible repairs! Let me share some of them with you.

Componentize improvements - Just as a big forest is made of many smaller separate trees, so is an extensive plan of improvements made up of a series of smaller, separate repairs. That is, much work resulting in the "permanent improvement" to a property, in essence, consists of a series of "separate repairs". Such repairs could be immediately deductible if documented separately. Otherwise they will lose their nature as repairs if they are part of a general plan of improvement or reconditioning. You therefore need to componentize or fractionalize the large expenditures into a larger number of smaller repair categories. Do this with *separate* invoices for each repair job.

Documents (such as bills & contracts) should be worded as "repairs" - Use such words as: "repairs", "prevent damage", "patch", "temporary", "incidental", "minor", "fix", "piecemeal", "annual", "less than a year", "decorating", "painting", "small", etc. Also, the prefix "re" is effective. For example, "*re*paint", "*re*match", "*re*paper", "*re*coa*t*", "*re*surface", "*re*do", etc. These have been in the taxpayer's favor in deciding that expenditures were repairs. Do the above and put more tax-saving dollars in your pocket!

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8. <u>REAP MORE DEDUCTIONS</u>: Employ Strategies To Find Overlooked Deductions For More Savings. As we have seen, real estate investors can increase the return on their real estate by increasing the tax savings generated from these properties. Another way to increment tax savings is to find more overlooked deductions. Some examples: Home office expenses; business travel, entertainment, family members on payroll (including using baby photos for marketing); fringe benefit deductions for family employees and others.

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9. <u>AVOID PASSIVE LOSS LIMITATIONS</u>: Deduct Unlimited Property Tax Losses Even if Over $25,000 or Your Income is Over $150,000 by Being a Real Estate Professional.

With the aforementioned non-cash componentizing deductions piling up, your properties are going to be throwing off paper tax losses which you want to fully deduct against your other income.

Except for $25,000 of losses, rental property losses are subject to passive loss limitations. This means real estate investors cannot deduct property tax losses against non-passive income such as salaries, business income, gains, IRA distributions, etc. If the investor's adjusted gross income (AGI) is above $150,000 they will not even be allowed the $25,000 exception for deducting such losses. Moreover, even if the investor is eligible for the above

exception, but has over $25,000 in property losses, the excess over the $25,000 is still subject to the limitations. Being subject to these limitations means the investor cannot currently deduct the losses in the year incurred. The losses are "suspended" and must be carried forward until the property is sold at a gain. The savings from the losses are also delayed as well as the investment use of such savings.

What to do: To avoid being subject to these limitations, the investor must document at least 751 hours (or an average of about 14-1/2 hours a week) with the majority of their time in the real property business. A "real property trade or business" is defined as *any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.* This includes real estate investors who do rentals, management, rehabbing, wholesaling, retailing, foreclosures, short sales, self-storage and other type's real estate activities. With the right planning and documentation even those with full time jobs can meet these requirements.

Do this and fully deduct your property tax loses without limit, save a ton of taxes, and increase your cash flow every year!

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10. <u>AVOID BEING A DEALER</u>: The First Planning Strategy For Reducing Taxes On The Sale of Property At A Taxable Gain is to Avoid Costly Dealer Status. When you start to get into "selling" scenarios (such as wholesaling, retailing, options, lease-options), the IRS (or your CPA) very may try to classify you as a dealer. Being tagged as a dealer could be a financial disaster because, unlike an "investor", you are subject to the highest ordinary income tax rates, plus Social Security taxes, and possibly alternative minimum taxes. Thus, 50% or more of your hard earned profits could be drained by taxes. Moreover, dealer profits (cash or paper) are <u>immediately</u>

taxed in full and cannot be tax-deferred in any way including not being able to use a 1031 exchange, seller financing\installment sale, a self-directed IRA, or any other tax-free exit strategy. Being tagged as a dealer could wipe you out! On the other hand, if you demonstrate status as an "investor" you can avoid these expensive dealer pitfalls.
First off, just because you start to flip\sell properties does not mean you are a dealer. Based on numerous tax courts cases (including a Supreme Court Case); actual IRS audits; and my extensive research; with planning, even a very large number of sales (in one year) could avoid dealer status.

Altogether, there are over 30 strategies to avoid the costly consequences of a dealer. My experience indicates that one of the best strategies is *investment intent*. That is, demonstrate that the primary purpose of the quick sale profits is for *investment* purposes and not sales speculation. For example, the primary purpose (or purposes) of the quick sale profits can be for a number of "investment necessities", such as down payment funds to acquire long-term investment keepers, or working capital for property investment operations including preventive maintenance.

With this premise, tax follows economics as opposed to sales speculation with tax avoidance motivation. That is economics first! Accordingly, as employed here, these flips are non-dealer, investment transactions with solid economic foundation. This is a very powerful defense against any IRS attacks. Consequently, there are numerous cases and scenarios, some of which I have had firsthand experience with, where even a huge number of sales in one year did not cause dealer status.

Moreover, there has never been an issue of civil or criminal fraud with the issue of investor versus dealer. Entrepreneurs have literally sold hundreds of units in a short time; claimed not to be a dealer without issues of fraud and, with the right planning and documentation, even won their case. *Reason*: The

issue is a very arbitrary question of fact and not of law. Accordingly, asserting any type of fraud (where the burden of proof shifts to the IRS) is very difficult and almost impossible. Therefore, real estate entrepreneurs have everything to gain and little (if any) to lose. They should do so by planning in advance with dealer-avoidance strategies (especially *investment intent*); avoid inept advisors, and GO for it!

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11. SELL YOUR PROPERTIES TAX-FREE: Avoid Paying Capital Gain Taxes On The Sale Or Disposition of Property.

Once you avoid being a dealer, you can sell your properties on a tax-deferred basis. First off, there is the 15% myth. In most cases the "total" capital gain rate is not just 15% (as if that's not enough!). The 15% is just the federal capital gain rate, but there is also depreciation recapture which is at higher rates, there is also AMT at higher rates and other hidden federal tax liabilities along with state or local taxes. Thus, your total rate on gains could be 25%, 30% or even higher. Once you avoid being a dealer there are numerous legal strategies to sidestep paying taxes on the sale of investment property.

1031 Exchange – One such strategy is a 1031 exchange which can totally avoid all of the above tax liabilities (including recapture) so you can keep all of your equity. One of the requirements for a qualifying 1031 rollover is that the properties must be "like-kind". But the term "like-kind" is not nearly as narrow as it sounds. 1031 rollovers apply to a diversity of small, large, residential, commercial, industrial, rural, resort-area or any combination of such investment properties. Examples are: rental houses, condos, duplexes, apartment buildings, land, marinas, trailer parks, shopping centers, retail stores, office buildings, motels, hotels, B&B's, parking lots, golf courses, quarries, ranches, farms, trailer parks, garages, warehouses, plants, factories, self storage facilities, even ground leases, improvements, easements and certain time shares. Even raw land can be rolled over into cash-producing rental property (or vice versa). *Several* properties can be disposed of, or

acquired via the same 1031 rollover. There is a gourmet variety of diversified options.

Understand, 1031's do not just defer taxes, but by having the interest-free and payment-free use of the tax savings, you have more buying power for the replacement property. For example, if you save $20,000 in taxes by doing a 1031, as a 10% down payment, $20,000 empowers you to buy another **$200,000** worth of real estate. In fact, many times, the 1031 savings, combined with leverage, is the difference that makes the difference in doing the deal. My students like to use the higher *un*taxed equity from a 1031 exchange to roll over into property they intend to keep so they can reap the cash flow, equity buildup and tax deductions (esp. depreciation) you get with keepers.

All of the above culminates into one significant power -- The ability to create pyramiding wealth accumulation in real estate ownership.

Reverse Exchanges – A way to bypass exchange deadlines and not rush into a bad deal! The majority of 1031 exchanges are forward exchanges where the relinquished property settlement is before the settlement of the replacement property. That is the replacement property is acquired after the closing of the relinquished property. Forward exchanges have two time deadlines – 45 days to identify replacement property and 180 days to close on identified replacement property (the 45 days comes out of the 180 days). These deadlines could pressure you into rushing into a property that may not meet your investment criteria.

A *Reverse "Starker" Exchange* is where the above closing of the properties is reversed in that the replacement property is acquired *before* the closing of the relinquished property. A reverse exchange that is properly restructured can bypass the 45 and 180 deadlines and qualify under IRS rules. In another

words, by not yet closing on their relinquished property to be sold, the real estate entrepreneur does not have to rush with 45 days to identify replacement property along with 180 days to close on replacement property. They then can take their time to search out for leads for excellent below market buys especially for properties at the bottom of the cycle. This is especially so for larger property which also may be located far away from your home base such as when you are looking to invest in another location where the prices of properties are at the bottom phases of the real estate cycle.

In the situation of holding off selling your relinquished property, it's possible that you do not have to do a reverse exchange and still not deal with the deadlines. This can happen when you have a patient seller of the replacement property who is willing to wait until you close on your relinquished property. Here, once you close on your relinquished property, you can quickly do a regular forward exchange. Unfortunately not all sellers are impatient, especially motivated ones. You therefore may have to negotiate for more time including giving a larger earnest money deposit, less or no contingencies, or something of value. Otherwise, there is the option of a reverse exchange which is being done by real estate entrepreneurs across the nation.

Self-Directed IRA – Another vehicle I like for avoiding taxes on gains is the self-directed IRA (SDIRA), especially for quick flips. A SDIRA is just like any other IRA (regular or Roth), except that *you* decide where to invest the funds, as opposed to some institution. It is recommended that you use the SDIRA for real estate transactions that generate immediate (or almost immediate) taxable income (such as flips or options) and generally not keepers that already shelter other income via componentizing.

A FINAL NOTE: You will never build up a huge portfolio when you pay too many taxes as it will take you an extra 10 to 15 years. Saving taxes is foundational to wealth building!

The above are excerpts from *The Renaissance Goldmine of Goldmine of Brilliant Tax Strategies Real Estate Investor's*, A Tax Reduction Software System by Albert Aiello. For more info go to www.TractionREIA.com/al

QUESTIONS TO AL – RESOURCES FOR MORE INFO

The Q&A helpline with Al is only available to Al Aiello students who have purchased one or more of his home study systems as follows:

The Renaissance Goldmine of Brilliant Tax Strategies For Real Estate Investors - Easy-To-Use Software Program That Will Dramatically Increase Your Cash Flow With The Absolute Best Tax-saving Secrets in The Country, *Specifically* for Real Estate Investors. Includes a Q&A helpline for *real estate tax* questions. For more info go to **www.TractionREIA.com/al**

The Ultimate Tax Bible for Self-Employed Entrepreneurs - The Consummate Tax-Reduction System for Small Businesses, Home-Based, Independent Contractors and Other Business Entrepreneurs. Includes Superb Strategies (different than the Goldmine above) That Will Legally Save You Hundreds…Even Thousands of Dollars More In Taxes! Includes a Q&A helpline for *business tax* questions. For more info, email **info@TractionREIA.com** and request "Tax Savings Business Owners"

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