Millionaire Tax Strategies

for

Real Estate Investors

Little-Known Ways for Real Estate Entrepreneurs to Create Enormous Tax Savings and Build Millionaire Wealth

Albert Aiello, CPA, MS Taxation, Real Estate Investor

Contents

About Al Aiello, CPA, MS Taxation, RE Investor, RE Broker....

Al is a national speaker specializing in *Wealth Protection* teaching dynamic strategies on tax reduction, IRS audit-proofing, entity structuring and asset protection targeted for real estate investors and business owners. He 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, not an easy accomplishment. Subsequently he got his Masters in Taxation graduating with the highest honors in this rigorous program. He was immediately hired as professor where he taught partnerships, corporations, asset protection and real estate taxation (a course that he created and developed). He has been a business owner since 1980 including having had his own tax practice that specialized in real estate and IRS representation. He has since sold his practice and today he is still an investor and a researcher constantly looking for ways to protect the wealth of real estate and business entrepreneurs. As a national speaker, with his home study courses, he has thousands of students across the country that use his strategies to pay little or taxes, to audit-proof their returns against the IRS and to protect their wealth.

"*Albert Aiello is one of the most trusted scholars in real estate taxation and 1031 exchanges in the country.*"

...Al Brindisi, CPA, MBA, Former IRS trainer, Director of Graduate Taxation

Millionaire Tax Strategies for Real Estate Investors

Albert Aiello, CPA, MS Taxation, Real Estate Investor

Published by: *ISU*\Information Services Unlimited
Phone: 1-215-271-1998; Fax: (215) 937-9205; Email: isu/janinepratt@aol.com.
Web site: www.REINFO.com

DISCLAIMER

These materials are designed to provide informative and useful information. Tax laws are subject to change and vary according to individual circumstances. *ISU* is *not* in the business of rendering tax, legal, or other financial advice. Where the situation dictates, a more thorough research of the applicable tax law (or other data) may be necessary as well as the advice of a competent professional.

CPA ALERT

Because most are not *Real Estate Tax Specialists*, most CPA's and other tax advisors may not be totally familiar with the legal documented content of this publication. Sources of more info are contained toward the end of this publication.

NOTE THE FOLLOWING

Federal Tax Law: Unless indicated otherwise, the contents of this publication pertain to *U.S. federal tax law* and not state or local law. State and local tax rules vary from locale to locale. Many states piggyback to federal law. Check the rules of your own locale or with competent tax counsel. Tax brackets are sometimes rounded for purposes of simplicity. Internal Revenue Code is abbreviated "IRC".

Millionaire 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. Here is why...

With an investment property there are 7 potential sources of wealth:

1. Cash Flow Income - from rents

2. Cash Flow Income - from rent increases

3. Cash Flow Income - other sources (storage, laundry, parking, upgrades)

4. Equity Accumulation - from buying below market ("instant equity")

5. Equity Accumulation - from upgrading ("forced appreciation")

6. Equity Accumulation - from mortgage amortization ("forced savings")

7. Equity Accumulation - from natural appreciation, plus...

Not only can you shelter all of the above sources of wealth from being taxed, but you also can go further and create paper tax losses that reduce other sources of income, creating an 8th source of wealth...

Tax Savings, even *huge* savings!

Unfortunately most real estate investors (and CPA's) are not aware of these golden opportunities, but you will be.

"*The idea is there, locked inside. All you have to do is remove the excess stone"*. - Michelangelo.

So let's go for it! We will discuss some of the most powerful strategies you can do to save taxes every year and thus increase your wealth as a real estate investor.

1.

SAVING TAXES ACCELERATES WEALTH

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 rental units 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?

Note: Selecting the right entity is one of the first things you should do. However entity structuring includes significant tax and IRS matters which you should know first, before learning about entities. Therefore entity selection & structuring is discussed in a later chapter (Ch. 16).

Of course you can refer to any part of this publication at any time.

2.

AVOID IRS

Employ "Audit-Proofing" Techniques to Be Free of The Worry & Costs of IRS Intervention

---

You can be creative & aggressive. Once you eliminate IRS fear and reduce your chances of an audit, you can be more creative & aggressive with your tax reduction planning. Being *creative* is to "evolve from one's imagination, as a work of art or an invention". Real estate is the greatest arena for creative minds! Accordingly, dramatic tax savings can be attained by the imaginative structuring of real estate transactions. *Aggressive* is "vigorously energetic, especially in the use of initiative". Therefore, being aggressive is <u>not</u> lying, stealing or cheating! It's taking the initiative to vigorously pursue every legal tax saving idea that you are entitled to. With real estate there are hundreds of these tax saving ideas, just waiting to be used. Moreover, most of what is covered in this publication is not even aggressive – it is boring black & white compliance. It's just that certain strategies (such as component depreciation in ch. 5) are perceived as aggressive because the person never heard of it. And even where the tax law is gray or controversial (such as *investor v. dealer* in ch. 12); it is in these controversial areas that you can be legally & discreetly aggressive and structure the tax transaction in *your* favor (as I show you in ch. 12).

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"*.

There are over 30 ways to audit proof your return against the IRS. Here are three powerful ways:

(1) File an extension for your tax return. File as late as legally possible, which typically is October 15* following the tax year.

Reasons why extensions reduce audits: A tax return filed around April 15 generally has a greater chance of being audited then one filed on October 15* (the latest possible date). This is because of the IRS computer's "first come, first serve" system, where returns filed early are more prone to audit. The extended returns may never find its way into the second later "audit" batch slated for examination.

(*For most entities, such as LLC's, partnerships and corporations, the extension date is September 15, not October 15).

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 such as extending the time to make tax-deductible contributions to certain retirement plans for the prior tax year.

(*If you do owe, you should pay at least 90% of the tax liability).

(2) Attach written explanations to your return, for items that you believe unusual or audit prone. Returns that are initially selected for audit by the IRS computer are then sent to the IRS District Office. Here an IRS evaluator (or screener) will carefully review every page of the

return to make a final determination if the return has enough “audit potential” to be selected. The evaluator can only select so many returns. One effective way to STOP the audit is to attach an *audit-proofing statement* with the appropriate tax law citations.

Example: On your tax return, a rental property that is not yet actually rented, showing NO income, but a bunch of expenses (including depreciation), could be an IRS red flag with audit potential. Therefore attach this audit proofing statement behind the IRS rental property schedule:

As per Internal Revenue Code Section 183, there is intent for profit. Separate business records are kept. Property has been actively & vigorously held out for rental during the tax year, including being advertised and listed with a Realtor, management company (or whatever marketing efforts you use) *The rental market in this area has been slow* (or for whatever reasons such as for a non-paying tenant, unqualified tenant, etc.) Continuing on...*During the vacant period the property has not been used personally by anyone at all. The primary intent is to rent the property as soon as possible and not for personal-use (per Internal Revenue Code Section 280A).* Then sign and notarize the statement.

Positive result. You have shown to the IRS your meticulous attention to detail, knowledge of the tax law and the applicable tax law citations. They do not want to waste their resources by auditing such knowledgeable entrepreneurs, because there is not likely to be the audit potential of an increased tax assessment. While no guarantee, this should help to keep you out of the audit pile.

(3) Avoid Schedule C's and E's, file form 1065 (Partnership return). Being conservative about your taxes does not necessarily reduce your chances of an audit; while, on the other hand, being creative & aggressive (per the above) does not necessarily increase your chances of an audit, if you know what to do. Just by knowing which tax forms to file (or not to file), you can substantially reduce your chances of an IRS audit! For example, instead of filing the highly audited Schedule C or E, file IRS Form 1065 - Partnership Return. This will reduce your chances of an audit. The preferred entity for real estate is the LLC which can file a partnership return with two or more members, such as spouses or others. Entity structuring is further discussed in Chapter 16

AVOID INEPT CPA'S

Fire-Up, or Fire Your Tax Advisor

(Note: "Tax advisor" and "CPA" will be used interchangeably)

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:

Q. *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. <u>I am not in any way advocating anything illegal</u>. I am simply using humor to get this point access - 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.

Q. *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.

Q. *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. (Audit proofing techniques were discussed in the last chapter. If the prospective CPA does not know about them, move on).

Q. Can you provide references from <u>real estate investor clients</u> as to your quality of service? When you are checking with the reference ask <u>specifically</u>, 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

(3) Alert you to IRS audit red flags

(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!

<u>Do not limit yourself to just someone "local"!</u> This is a frequent BIG mistake made by investors. With today's technology we are closer to each other than ever before, despite being many miles way. Plus, the field is simply not crowded with highly competent real estate tax specialists. I have many students use a highly qualified <u>and concerned</u> tax specialist who is not local. They consequently save thousands every year. <u>Don't let mere</u>

physical distance get in the way of money-saving advice!!

NO CPA? Like a bad tenant...having NO tax advisor is a heavenly dream next to having a bad one. Many of my students do not have a CPA or use one on a very limited basis. Instead they use a good home study course on real estate tax reduction along with tax preparation software such as *TurboTax*. They rave about how they legally save more money than they did previously with a CPA, but without the high fees. Now this is not for everyone. But if you do use a CPA, make sure that *you* have at least a general understanding of real estate tax law and that the CPA is working for *you*; because no one cares more about your money than YOU!

4.

HOW TO STOP PAYING UNNECESSARY EMPLOYMENT TAXES

While it is Ordinary Income, Rent Income is Not Subject to Social Security taxes

---

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, even if you own a thousand units and even more.

ALERT: 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 about $10,000 in taxes! Ouch again!!

NOTE: There are many deductions that can substantially lower rent income and even create a "paper" tax loss, where instead of paying any taxes at all, you *save* taxes and put money in your pocket. See the next chapter.

5.

THE POWER OF DEPRECIATION - THE AWESOME POWER OF COMPONENTIZING DEPRECIATION

Substantially Increase Depreciation Deductions Via Componentizing (Cost Segregation Analysis)

First let’s discuss the POWER of depreciation just by itself.

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. (You just take it!) 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 in Chapter 13). 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!

As impressive as this is, most tax advisors do not determine the maximum depreciation deductions you are entitled to. *Reason*: They typically allocate the property cost with a high land value (no depreciation here), and the remainder to the building which is depreciated over 27-1/2 years straight-line (for residential rental property) and 39 years (for non-residential commercial real estate).

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. My students also use it with the same money-saving results.

Reason: With componentizing, besides the building portion, you break out components from the property cost, that allow you to use much shorter recovery periods than 27-1/2 or 39 years, 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 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, under the tax law 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. <u>Tax savings of over $5,000 for the next 5 years</u>! Plus Ron expanded his rental market with the movable walls giving his tenants more options as to office space size. I have students doing the same strategy with their residential multi-unit properties.

There are many other items of such personal property fully supported by many tax law citations, such as IRS Regulation 1.148-1(c).

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, parking lots and many more items fully supported by tax law citations such as Internal Revenue Code Section 168(b)(2).

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 the above 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, *Platt* (75-1USTC).

<u>EXAMPLE – BEFORE & AFTER</u>: Let's look at an example of a $250,000 duplex. *Before*: Your tax advisor, "Pistol Pete Preparer" quickly allocates 20% of the $250,000 or $50,000 toward the non-depreciable land = No deductions here. The remaining 80% or $200,000 toward the building is depreciated over 27-/12 years (straight line) and for you this equates to only about $7200 a year. <u>You are losing a lot of savings</u> as you will see next.

After: Now with the componentizing (cost segregation) method, allocation of the cost to the components follow:

Property Component	Allocated Amount	Depreciation (1st year)
Personal property	$33,250	$6,650
Land improvements	13,750	687
Building	192,750	6,717
Land (left over)	10,250	0
TOTAL	$250,000 Cost	$14,054* (first year)

*The $14,054 first year depreciation deduction is almost double Pistol Pete's deduction of $7200! Moreover, in the second year the componentizing depreciation deduction would be $18,954 or over two and half times Pistol Pete's deduction of $7200!

Note: The above allocations to the various components are based on certain IRS acceptable valuation factors beyond the scope of this publication. As presented here, they are on the conservative side.

Another componentizing strategy is to fully deduct the remaining basis of components that are replaced (gutted out).

For instance suppose you are partially or totally gutting out a property, ripping out the floor, walls, plumbing, heating, etc. Here, you can attain huge deductions by fully deducting the remaining basis of these components as per the above.

For example, Ed does a component breakdown of all property components in one of his properties. Ed likes new components for better preventative maintenance. Ed completely gutted out and replaced a number of these components. They are being retired and therefore are eligible to be fully deducted. The components to be gutted out by Ed are listed below along with their original allocated cost:

Bathroom fixtures	$ 4,044	Roof	3,561
Flooring	2,827	Walls, inter.	10,638
Heating	3,860	Kitchen fixtures	6,700
Plumbing	4,150	Total	$35,780

Ed fully deducted the above $35,780 of retired components in one year as an ordinary non-cash deduction without passive loss or alternative minimum tax limits. In a 31% tax bracket that's an immediate tax savings of over $11,000 with no cash out!

So how much extra did you pay in taxes *not* using componentizing because your CPA did not know about this incredible legal strategy? According to the above and the follow quote from one of my students, 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!!

6.

DEDUCT ASSETS ALL IN ONE YEAR

Fully Deduct Certain Personal property All in One Year Via Section 179 First Year Expensing

---

One Year Full Deduction. Instead of being deducted over 5 years (which is good) but even better, certain (but not all) personal property can be fully deducted all in one year under IRC 179, within certain limits. This means even faster tax dollars in your pocket!

For example, in a 30% bracket, a $20,000 first year expensing deduction immediately saves you $6,000.

Present 179 limit. At the present time the 179 limit is $250,000 but this could be subject to change. Seek competent tax advice or refer to the resource section at the end of this publication.

New or used. Section 179 first year expensing pertains to new and used qualifying personal property assets.

Not All Personal Property With Real Estate Qualifies. Read on.

First-year expensing cannot be used for personal property in residential rental property. Any personal property (appliances, carpets, furniture, etc.) in *residential rental* properties (rental houses and apartments) as described in Section 50(b) which includes "Property used for lodging", which is residential rental properties (not hotels or motels).

It also cannot be used for air conditioning or heating units in any type of property. See *The Small Business Act of 1996*. However, such personal property is still entitled to the

big 5 year write-off.

First-year expensing *can* be used for personal property in commercial property. Personal property in office buildings, shopping centers, warehouses, other types commercial property including hotels and motels.

First-year expensing *can* be used for personal property associated or ancillary to any type of real estate, residential rental or commercial. Examples are: Computers, faxes, furniture, etc. used in a home office to manage properties (residential rental or commercial). Also included here would be maintenance equipment such as trucks, tractors, trailers, lawn mowers, snowmobiles, tools, etc. Also included are laundry equipment, storage units, shelving, sheds and other such movable facilities. These would also qualify for the full Section 179 deduction as ancillary items for both residential rental or for commercial property.

<u>EXAMPLE</u>: One of my students (Richard) was able to fully deduct, all in one year, the $50,000 cost of the above type ancillary personal property associated with his multi-unit property. In his tax bracket that <u>saved Richard $15,000 on just this one strategy</u>!

Further IRS requirements and income limits apply to Section 179 first year expensing. Seek competent tax advice or refer to the resource section at the end of this publication.

50% Bonus Deprecation is Back

Qualifying property. Bonus depreciation (50%) pertains to *new* depreciable property with a recovery period of 20 years or less. This includes new 5 year personal property and new 15-year land improvements which are part of the cost of a rental property under the componentizing method of depreciation discussed in the last chapter.

For new personal property this means an upfront deduction of 50%, with the balance depreciated over 5 years and the possibility of 179 first year expensing. Qualifying *new* personal property is eligible for 50% bonus first-year depreciation where you can deduct 50% of the cost of such personal property in the first year. The balance of the cost is deducted with 5-year depreciation. You can also, first, claim Section 179 first year expensing for qualifying personal property (previously discussed) and then use the 50% bonus depreciation, with any balance deducted with 5-year depreciation.

***New* assets only**. But bonus depreciation is limited to new assets - those which are first used by the taxpayer. If *used* assets are purchased, no 50% write-off is allowed. But for qualifying personal property (new or used), Section 179 first year expensing is permitted as previously discussed.

New personal property in both residential rental and commercial property qualify. 50% bonus depreciation qualifies for new personal property such as new appliances or kitchen cabinets. This would include all personal property in newly constructed property, both residential rental and commercial real estate. So while personal property in residential rental property does not qualify for Section 179 first year expensing, *new* personal property in residential rental property does qualify for 50% bonus depreciation.

New land improvements (15 years) also qualify. 50% bonus depreciation qualifies for new land improvements such as new landscaping, paved surfaces and parking lots. This would include all 15-year land improvements in newly constructed property, both residential rental and commercial real estate. (Section 179 first year expensing does not at all pertain to land improvements)

Bonus deprecation may be subject to change or expiration. Seek competent tax advice or refer to the resource section at the end of this publication.

7.

GENERATE REPAIR DEDUCTIONS

Employ Strategies To Reclassify Rehab Improvements Into Fully Deductible Repairs - Immediate Savings In Your Pocket

---

Repairs are fully deductible under Regulation 1.162-4. 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.

(1) Componentize the 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 could 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 expense categories. Do this with *separate* invoices for each repair job. This is what the court said in *Cobleigh*, TC Memo, 1956-261.

EXAMPLE: Here is an example of how an improvement of $20,426 was fractionalized into smaller repair expense categories.

Schedule of Deductible Repairs And Maintenance

Description of Repair/Maintenance Item	Cost
1. Repair a leaking roof	$ 826
2. Extensive repairs to ceilings	1,680
3. Painting to ceilings	2,500
4. Extensive repairs to walls	1,982
5. Painting to walls	2,500
6. Floor mending\resurfacing	1,888
7. Carpet repairs	810
8. Replace broken windows	2,951
9. Heating repairs	509
10. Electrical repairs	1,020

11. Lead paint removal	1,635
12. Cleaning	400
13. Cleaning supplies	200
14. Decorating	625
15. Equipment Rental	200
16. Exterminating	500
17. Locks & keys	200
Total repairs & Maintenance................	$ 20,426

Positive result: Instead of one $20,420 “capital punishment”. You have 17 deductible repairs generating immediate savings in your pocket.

Audit-Proofing Tip: Attach the above schedule to your tax return behind the IRS rental property schedule such as 1040 Schedule E or the more preferred Partnership 1065 behind the rental property form (8825) *Reason*: Such attention to detail could ward off any IRS attacks.

(2) 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*coat”, “*re*surface”, “*re*do”, etc.

Reason: These have been in the taxpayer's favor in deciding that expenditures were repairs.

<u>ALERT</u>: The wording on the bill should not be deceiving with the intent to falsify information.

Do the above and put more tax-saving dollars in your pocket!

<u>8</u>.

REAP MORE DEDUCTIONS

Overlooked Deductions for More Savings

Besides the powerful componentizing deductions, there are deductible expenses that are often overlooked and are another way to increment tax savings. They are called “overhead” expenses because they usually pertain to the entire real estate operation, not just any one property. These expenses are deductible generally under IRC 162 as ordinary and necessary expenses. They follow:

_____Auto expenses

_____Entertainment

_____Telephone

_____Internet/web site fees

_____Voice mail or answering machine

_____Office-in-home

_____Office equipment & furnishings *within* the office

_____Office supplies, stationery, postage, etc.

_____Family members on payroll

_____Travel out-of-town

_____Books on real estate and related topics

_____Subscriptions to real estate and business magazines.

_____Tools & supplies

_____Equipment rental

_____Eviction costs

_____Professional fees

_____Dues for investor groups or associations

_____Tuitions for real estate courses and live conferences. IRS

Regulation 1.162-5.

The best IRS form for deducting these overhead expenses for real estate is - partnership 1065, not Schedule E. For real estate these type expenditures are "overhead" expenses that pertain to the entire real estate operation instead of just one property. When you deduct them on Schedule E, you either have to prorate them according to each property listed, or use one "property" column on Schedule E just for these overhead expenses (not a property). Either way it's awkward and more importantly could cause your Schedule E to be even more audit-prone. On the other hand, rather than Schedule E, the partnership 1065 form has lines and spaces where such expenses can be inserted and will easily blend right in. As discussed in Chapter 16, forming an LLC adds the limited liability protection to the tax-favored, less audit-prone partnership (1065).

<u>WARNING</u>: Do NOT use Schedule C at all. *Reason*: Schedule C's are more audit prone than Schedule E's. Also if there is net taxable rent income, IRS may expect you to pay Social Security taxes when you should not as discussed in Chapter 4.

9.

AVOID PASSIVE LOSS LIMITATIONS

Deduct Unlimited Property Tax Losses Even if Over $25,000 or Your Income is Over $150,000

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. Investors can generally deduct up to $25,000 of property tax losses. Beyond this first $25,000 of tax losses, rental property losses are subject to passive loss limitations. This means real estate investors cannot currently deduct property tax losses against ordinary 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 tax 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 against their other income in the year incurred. The losses are "suspended" and must be carried forward typically until property is sold at a gain (passive income), where the losses can then be used against such passive income.

(So they are not wasted)

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 a majority of their total time in the real property business.

A "real property business" is defined as *any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing or brokerage trade or business.* IRC 469(c). This includes real estate investors who do rentals, management, rehabbing, wholesaling, retailing, foreclosures, short sales, commercial, brokerage and many other types of real estate activities. With the right planning even those with full time jobs can meet these requirements. Here is how...

Tax experts believe that just by documenting the 751 hours per year (an average of 14-1/2 hours a week) of real estate business activities (including management), should be sufficient to be a real estate professional* and fully deduct rental property losses all in one year, regardless of the amount of loss (even if over $25,000 and/or AGI is over $150,000).

[*A *real estate professional* is not a licensing requirement but instead meeting the real estate business hourly requirements as per this discussion]

But even if you are concerned that you should put in more hours than your job, there is this:

Not just hours at the job. It's not how many hours you are *at* your job, but the actual "personal services" you actually perform at the job; again, not the time you are at the job. IRC 469(c)(7).

40 hours is not 40 hours. So a 40 hour a week job is not 40 hours of actual personal services. Allow for "down time" such as holidays, sick days, personal days, lunch breaks, coffee breaks, "BS" time, etc., it's really 30 hours (often less) on an average. Down time hours could be used to incur hours in your real estate business, such as calling on real estate ads or researching real estate investing strategies on the internet while you are in the break room or your days off.

Outside office/easy boss/self-employed. If you are frequently outside of the office, or have an easy boss, it could even be less than 30 hours. One of my students was an outside sales representative for a large company and actually put in 20 hours maximum at his job, many times less. Time outside the office could be used to incur hours in your real estate business such as riding around looking for bargain buys, making actual offers in person, or attending foreclosure sales. If you are self-employed all of this will even be easier.

Travel time. There is also travel time between home and the job (and back), which for some people is 20 minutes and for others 2 hours. Travel time hours could be used to incur hours in your real estate business such as listening to educational tapes on operating and managing your real estate business. You could also use your cell phone to conduct real estate business while driving, (but only use the *safety* *type* of phone set up where you can talk without holding the phone; also be aware of state laws on using your cell in the car). If you use public transit, than all this is even easier including checking newspaper ads for bargain buys or reviewing a real estate proposal on your laptop and responding with text messages.

Work weeks during the year. The other factor is how many weeks you work during the year at your job. Most people get at least 2 weeks' vacation but often get more (such as 3 or 4 weeks). You can incur hours in your real estate business by making your vacations deductible business travel looking for out-of-town properties or attending a real estate convention, as a number of my students do all the time. In two weeks you can incur at least 70 or 80 business hours. Another one of my students was laid off for almost half the year. It consequently was a cake walk for him to incur more than enough hours.

<u>SPOUSES' HOURS CAN HELP</u>: One spouse meeting these time tests can still allow an inactive owner\spouse to qualify for this provision on a jointly filed return. Here is an example of two of my husband & wife students - John & Mary's AGI is over $150,000 and their rental property tax losses are $75,000. Mary (who does not have a full-time job) works an average of 15 hours a week in their real estate business. John stays at the same full-time job, unrelated to real estate. On a jointly filed return, John & Mary can now fully deduct the above $75,000 losses all in one year, without any limits. In a rounded 40% federal and state tax bracket, the $75,000 of tax losses creates $30,000 of immediate tax savings, adding to their cash flow.

Cut out excess J.O.B. hours. If you (and your spouse) still work too many hours where you think you will not be able to incur the necessary business hours, then cut out any overtime or work part time. (I have had students where one spouse quit their job altogether. But they did so where it was not a great financial risk to them; especially where there was a low-paying, time-consuming, dead-end job). Do this so you can then incur the necessary business hours. But you are not just doing this for tax reasons, but for <u>wealth building</u>. The extra time from not working on a regular job could make you a lot more money and build you a lot more wealth. Many of my students and I make more money on just one real estate deal than many make in an entire year at a "job". (And *now* is the time!) There are 8 potential sources of wealth from a rental property as discussed at the beginning of this publication. You will NOT get this at some J.O.B. > "Just-Over-Broke"!

Don't Get Audited! As per Chapter 2, IRS Audit Proofing, filing extensions reduces your chances of an audit. Also, file as a partnership where you report your property tax losses on IRS Form 1065, which at the present time, is less audited than other IRS schedules. (Selecting the right entity is discussed in ch. 16). The reason for IRS audit proofing is > NO Audit = NO issues (including costly passive loss limits). Not that you are doing anything wrong; you are not, as you are complying with the IRS requirements; and <u>you have every right to legally protect your return against IRS attacks</u>. *The IRS Restructuring and Reform Act of 1998*.

Plus, the real estate business activities that fulfill the IRS hourly requirements are many and can be easily documented. Some examples of these activities are:

Finding Property:

B-1. Check & review sources for finding investment properties

B-2. Develop a list of bird dogs as sources of good buys and motivated sellers

B-3. Meet with bird dogs as sources of good buys and motivated sellers

Due Diligence:

B-4. Do a market\location analysis including emerging or reemerging locations

B-5. Checkout specific neighborhoods performing a neighborhood analysis

B-6. Physically go out and search for investment properties

B-7. Contact prospective property owners

B-8. Do a preliminary qua*n*titative analysis on properties (such as the cap rate)

B-9. Do a preliminary "drive-by" property inspection

B-10. Make & negotiate purchase offers on property

B-11. Verify the income, expenses, vacancies on the property's operating statement

B-12. Review leases, utility bills, maintenance contracts, other pertinent documents

B-13. Do a thorough physical property inspection analysis

B-14. Obtain *Estoppel Statements* from the seller and tenants.

B-15. Forecast projected income & expenses for a total projected annual yield

Offers and Contracts:

B-16. Make final offers

B-17. Prepare contract for purchase of property

B-18. Review seller's contract for purchase of their property

Financing Property:

B-19. Check out sources of financing for acquiring property

B-20. Review Member credit reports; repair or correct accordingly.

B-21. Prepare a *Credibility & Profile Package*

B-22. Meet and develop rapport with lending sources

B-23. Prepare a *Loan Package* for a property acquisition

B-24. Arrange for financing for acquiring property

B-25. Negotiate the seller to hold financing

Closing Property:

B-26. Prepare for closing of the prop. purchase, such as arranging inspections, certs, etc

B-27. Do a pre-closing inspection of the property

B-28. Attend the closing of the purchase of the property

B-29. Take care of any post-closing matters

Follow-up:

B-30. Follow-up to see if any prior prospective sellers are more prone to renegotiating

B-31. Renegotiate the transaction to finalize the purchase as per the above list

There are many more of such activities involving operation, management, rehabbing, selling, exchanging, seminars, webinars, bird dogging for other investors, etc.

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

10.

POSTIVE CASH FLOW WITH PAPER TAX LOSSES

One of the Unique, Magical Virtues of Real Estate is Positive Cash Flow Yet Deductible Tax Losses, Creating Tax Savings

---

You have seen that the principal source of these tax losses is from huge non-cash deductions via the powerful componentizing system. Because the acquisition and rehabbing of real estate can be done via leveraging the componentizing deductions could be claimed without cash outlay, thus making them paper deductions that still create cash flow via tax savings. These componentizing deductions create paper losses that are deducted on your tax return (saving you taxes), but they are not reflected on your cash flow statement (causing positive cash flow). Therefore, the componentizing system not only totally shelters all of your real estate wealth, but even goes further by creating "paper" losses that reduce, or even eliminate the taxable burden from *other* sources of taxable income such as salaries, business income, interest, dividends, gains, etc. This in turn creates that 8th potential source of wealth...tax savings.

EXAMPLE: Positive cash flow of $12,380 yet with paper tax losses of $26,000

Positive Cash Flow: Property cost is $500,000 which includes purchase price and closing costs. You put $50,000 down and obtained a mortgage for $450,000, 8%, 30 years. Your total annual mortgage payment is $39,620 and the interest for the first year is $36,000. Below is a recap of the pre-tax cash flow analysis on the property.

1. Total Property Income....................................		$101,000
2. Less: Operating expenses & vacancies….......	-	49,000
3. = Net Operating Income (NOI).....................	=	52,000
4. Less: Annual mortgage payment....................	-	39,620
5. = Positive Cash flow before taxes.............		$ 12,380

The above property is generating an annual *positive* cash flow of $12,380, which divided by the $50,000 down payment equates to nice 25% cash-on-cash return. Not only is this large cash return totally sheltered by the paper tax losses below, but it creates tax savings (see next).

Paper Tax Loss = Tax Savings: By using the componentizing system, the annual componentizing deductions will be $42,000. Below is a tax analysis.

1. Net Operating Income (NOI), per the above...	52,000
2. Less: G.M. Componentizing deductions.........	- 42,000
3. Less: Interest deduction..................................	- 36,000
4. = Paper Tax Loss).....................................	$ (26,000)

In a 31% tax bracket, the $26,000 tax loss = $8,060 of immediate tax savings, which means an $8,060 increase to the above cash flow! Add the $8,060 to the pre-tax cash flow of $12,380 = after-tax cash flow of $20,440/ divided by $50,000 DP= an even nicer 41% cash return!!

Plus, the property will appreciate in value.

NOL'S = FOUND MONEY ($$$$)!

Net Operating Losses Generate Additional Cash in Your Pocket

The large amounts of component depreciation will often generate substantial tax losses big enough to create an NOL.

What is an NOL? An NOL (net operating loss) happens when your real estate and/or other business tax losses exceed all of your other income resulting in a *negative* taxable income. If you have real estate or business losses and your "total income" on page 1 of your 1040 (on about line 22) is a negative amount, then you have an NOL.

NOL Benefit. Presently, an NOL carryback enables you now to go back 5 years* and recoup past paid taxes which is like found money you can reinvest. (*was just 2 years). NOL's can alternatively be carried forward 20 years to offset future taxable income. (*Look out for possible legislation to increase the years of a carryback)

Other sources of NOL's. Besides rental property tax losses, some of the more common sources of eligible NOL losses are:

Your share of S-Corporation & partnership losses

Business losses (such as Schedule C losses)

Losses on the sale or disposition of rental or business-use property

Casualty & theft losses, both business & personal.

EXAMPLE: Your only income was salary of $50,000. You have the following tax losses.

Rental property tax losses......................................	($50,000)
Schedule C loss as a real estate agent...................	(10,000)
Your spouse's LLC loss in a part time business....	(5,000)
Your share of an S-Corporation loss....................	(10,000)
A casualty loss..	(5,000)
Total eligible losses...	($80,000)
Less: Salary Income..	$50,000
Equals: Excess of losses over income........	($30,000) NOL

Payoff: In a 31% bracket the above $30,000 NOL, as a carryback, can generate for you $9,300 in past paid taxes, plus interest= found money!

How to Benefit From an NOL – Filing IRS Forms

NOL's often overlooked. I have seen many taxpayers have an NOL and never use it. Some tax advisors even miss it (not surprising!) The above example should give you a good idea if you have one.

Filing IRS forms for NOL Carrybacks. You need to file the proper forms for an NOL to be carried back to recoup past due taxes. For NOL carrybacks (for refunds), individual taxpayers file IRS Form 1045 as a “quick refund” claim. You have 12 months to file Form 1045 after the end of the tax year. After the one year, individual taxpayers must then file IRS Form 1040X. With this form you have 3 years after the due date of your current’s year’s return. These forms must be done properly with certain attachments. Carefully follow the form’s instructions or seek competent tax advice.

NOL Carryforwards must be timely and properly elected. If there are no past taxes to recoup, you can instead elect to carryforward the NOL to offset future taxable income. The present carryforward period is 20 years. The carryforward election, which is irrevocable, must be made by attaching a written statement to your tax return, filed by the due date, including extensions.

NOL’s pertain to individuals, not to flow-through entities such as partnerships (including LLC’s) and S-corporations. NOL’s pertains to individuals and C-corporations; they do not pertain to partnerships including LLC-partnerships. With partnerships and LLC’s (or any other flow-through entities) it is the individual partner or member, who makes the election as part of their individual 1040 return, following the above rules.

NOL carrybacks generally do not trigger IRS audits. If properly done, most are processed routinely. So go for it!

State or local filings. The above rules pertain to federal taxes. State and local tax rules for NOL's may vary. Check the rules of your own locale or with competent tax counsel.

Tax Law Cites. IRC 172, Regulation. 1.172-1.

12.

AVOID BEING A DEALER

The First Strategy to Sell Your Properties Tax-Free is to Avoid Costly Dealer Status and Be Considered an Investor

---

Basic theoretical definitions – *Investor* v. *Dealer*: An "investor" holds real estate for longer-term cash flow and\or appreciation and may dispose the property at intermittent intervals, *Hardin* (1958), DC-FL, 3AFTR 2d 1146. On the other hand, a "dealer" acquires real estate as non-depreciable "inventory" with the sole intent for quick resale to customers in the ordinary course of business. The selling operations of a dealer are so extensive as to constitute a separate business, *Keeney* (1929) 17 BTA 560 (A). Between these two more obvious examples lies a controversial area, which can be a plus in avoiding being a dealer, with the right planning.

The tax drain of being 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 employment\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 taxed in full</u> and cannot be tax-deferred in any way. This means as a dealer, you would not be able to defer taxes by using 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.

In the real world of real estate, when you start to get into "selling" scenarios (such as wholesale flips, retailing, options, lease-options, etc.); the IRS (or your CPA*) very may try to classify you as a dealer. Even though they are typically wrong in doing so, without advanced planning, you may fall into the costly dealer trap.

*It's not just the IRS! Even more so, some CPA's, carelessly and incompetently classify investors as dealers. Here is a quote from one of my students, Craig from Ohio: "*My present CPA has documented (my tax returns) and portrayed my entrepreneurial endeavors as a dealer to the IRS and not that of a Real Estate Investor costing me several thousand dollars, and imminent amount of time required to correct the situation*."

Read this chapter and this will NOT happen to you!

First some background on the issue of investor vs. dealer.

IRS abuse of this issue - At one time capital gain rates were 20% and ordinary rates 70% in the 1970's and then down to 50% until 1986. During this period, with this much of a disparity, investor vs. dealer was a hot IRS target.

Consequently, vulturous IRS agents took advantage of this rate differential with the premise that anyone and everyone who sells property (even one sale) is a dealer. The big difference is collecting 50% (or 70%) of the gain versus 20%. IRS agents are rated and promoted on how well they do on audits and it does not have to be all fair. Here was a perfect opportunity for ambitious agents to call everyone dealers and collect more. With planning, much of this abuse could have been avoided. But a vast majority of taxpayers were unrepresented or ill-advised. They therefore did not do the necessary planning and paid the piper!

William Malat to the rescue! For investors a favorable turn of events occurred in 1966 in the Supreme Court's decision in *William Malat v. Riddell*, 383 US 569 (1966). Prior to this case the IRS and the tax courts were much harsher. Just about any type of sales activity could cause the taxpayer to be considered a dealer. However, after 1966 case law has often treated even "dealers" as "investors", when the facts supported an investor role. With *Malat*, the chances for entrepreneurs (including dealers) to attain favorable investor status have dramatically improved. The IRS must show that the taxpayer acquired the property with the definite and principal intent of selling it to customers in the ordinary course of business, with no other intent. Therefore, if the taxpayer can demonstrate that another principal purpose in holding the property was for *rental* or *investment* purposes (other than selling), they have an excellent chance of attaining investor status. Remember, *Malat* is a Supreme Court case, which has the force and effect of law. All courts and the IRS must abide by its decisions.

Quick selling and dealer status are not synonymous. Just because you quickly sell or flip properties (even a substantial number) does not mean you are a dealer. The Tax Courts have said that the activities of a real dealer are those of a full time builder/developer and not a part time wholesaler or rehabber. *Keeney,* ibid. See also

Fahs, 161, F.2D 315 (1947); *Dressen* (1952) 17 TC 1443(A).

Quickly selling properties and dealer status are NOT synonymous. You could have *non-dealer* flips for *investment* purposes for *investment* need by *investment* intent (discussed later). So STOP being scared off from making big money in real estate with flips, including tax-free flips via 1031 exchanges or self-directed IRA's.

To sell or flip properties, tax-free, the first strategy is to avoid being a dealer. Remember, a dealer has no strategy available to defer taxes on profits -- No 1031 exchanges, no self-directed IRA's; no seller financing\installment sale reporting; <u>no</u> anything. But with astute planning, real estate entrepreneurs could avoid the costly consequences of a dealer.

Total Dealer Avoidance - Strategies to avoid being a dealer on all of your properties – keepers and flippers. Altogether, there are over 30 strategies to avoid the costly consequences of a dealer. Here are a couple of effective ones.

1. Document investment intent via the Supreme Court Case, *William Malat* as part of the "Purpose" of your LLC operating agreement, which should state -- "To hold real estate for investment and rental purposes". Such wording indicates investment intent. (Do <u>not</u> use words like "*develop", "sale", "sell", "flip", "wholesale", "retail", "subdivide"*, "*subdivision"*, "*dealer", "trade" "turnover", "inventory",* or any other words denoting *intent to sell*).

2. The consolidated entity approach – One LLC-partnership for both keepers and flippers along with investment intent – NO corporations. This LLC-partnership entity is for both your flippers and your rental keepers. Why do it this way? The answer is to first look at the *wrong* way in doing it -- With the issue of investor vs. dealer, a conventional recommendation is to clearly *separate* the "dealer" property from the "investor" property by using a separate entity for flips (such as a corporation). But this recommendation is based on the position that all flippers are dealer property (which has been documented as not being true). Accordingly, you take a different position in that just because you start to flip properties, does not necessarily make you a dealer. With this "investor" position, you are instead consolidating the keepers and flippers into one entity where the keeper (investment) intent is dominant over the primary intent to sell as per *William Malat* (previously discussed).

Flip profits fund cash to the keepers. This is further supported in that, within the same entity, the cash profits from the quick sale properties are to be used to fund and support the *investment necessities* of the keepers, such as cash needed toward working capital for company operations; an emergency fund for property emergencies (such as an unexpected large repair or extended vacancy) and other such investment necessities. The result is we have one *investment entity*, not a dealer-sales entity. (Isn't this way you're suppose to run your real estate business?)

Investment Intent can also be demonstrated in a self-directed IRA. Here the sales within the IRA enhance *investment* performance where the resale profits fund and support the investment necessities of the assets held in the IRA.

Using a separate entity for flips = a sales intent = dealer status. If the flippers are by themselves in a separate entity (not with rental keepers) then the IRS is in a strong position to assert dealer status because it could be argued that the flippers (by themselves solely as resale flippers) are held primarily for sale to customers and are of first importance, *William Malat*, Ibid. That is, the sales purpose is dominant.

Investment intent is the anti-dealer nuclear weapon. Looking at it another way, the nuclear weapon that has been so effective in avoiding dealer status is “intent” that is based on investment intent, not sales intent. With a separate entity for flips there is *sales* intent = *dealer* status. With one LLC entity consolidating both keepers and flippers there is *investment* intent = *investor* status.

William Malat is a double-edged sword in that with *investment* intent you are on the right side of the sword but with *sales* intent you are on the wrong side of the sword.

How do you protect the equity of all these properties in one LLC entity? One way is put each property in a land trust with the LLC as the beneficially. Another way is *equity stripping,* which is using debt and liens as a deterrent to protect your assets by warding off claimants and their money-hungry lawyers. It is done by using your own separate company (a separate entity) to encumber all of your assets with secured debt with complete arm’s length documents. The end result is that your assets show no value and just about no one wants to sue people with no net assets. While a further discussion of this excellent asset protection strategy is beyond our scope here; the consolidated entity approach for avoiding dealer status and equity stripping for protecting your equity is a great all-in-one combination.

Final Point about Investor v. Dealer. 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 even won their case.

Reason: The issue of investor versus dealer 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 should be decidedly aggressive and astutely creative. They have everything to gain and little (if any) to lose. Entrepreneurs should do so by planning in *advance* of transactions; use the aforementioned strategies; and avoid inept advisors.

13.

SELL PROPERTIES TAX-FREE VIA THE 1031 EXCHANGE

Avoid Paying Capital Gains and Recapture Taxes When the Property Is Sold

---

No one can predict appreciation. But over time real estate does appreciate; and in up cycles substantially so. Appreciation, along with depreciation deductions, means large taxable gains on the sale of rental property. Once you avoid being a dealer, you can sell your appreciated properties on a tax-deferred basis.

Total tax rate on gains. Besides the present 15% federal capital gain rate, there is also depreciation recapture which is at higher rates and there could be AMT (alternative minimum tax) at higher rates; plus state or local taxes. Thus, your total rate on gains could be 25%, 30% or even higher.

1031 Tax-Free Exchange. One great strategy to avoid capital gains tax on the sale of a property (along with higher taxed depreciation recapture) is a 1031 exchange (so you can keep all of your equity). Briefly stated, a Section 1031 exchange (or rollover) is a legal tax provision that allows you to defer taxes on the sale of your investment property by acquiring another investment property within certain IRS requirements.

Not 2-way barter. One of the biggest misconceptions about exchanges is that they are “pure” exchanges or 2-way barter. This generally is not so. The buyer you are selling to, does not have to be the party you are acquiring the replacement property from. That party (the seller of the replacement property) can be a totally different party from your buyer, and they usually are.

“Like-kind” is a liberal requirement. 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 of like kind properties: 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. IRC 1031(a)(1) and many other tax law cites. There is a gourmet variety of diversified options.

Tax-Free vs. Tax Deferred. 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. (Assuming a 10% annual return, you reap $20,000 more income every year).

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 componentizing tax deductions you get with keepers.

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

TRUE STORY: My students, Joe & Joanne Dahlin, were almost poor owning a small multi-unit property in Minnesota. Via a 1031 exchange, they sold the Minnesota property (tax-free) and purchased the

Copper House Apartment Building in Tucson, Arizona. *Result*: They quintupled their cash flow & equity and ultimately become Millionaires!

Here is what made it all work for Joe & Joanne > Because their Minnesota property's equity was not drained by capital gains and recapture taxes, they were able to use the *un*taxed equity as a much bigger (required) down payment for the larger Tucson property. In other words, they could have *not* done the deal without doing the 1031 tax-free exchange!

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 that start from the closing of the relinquished property – 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 end up not meeting 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 your relinquished property to be sold, you do not have to rush with 45 days to identify replacement property along with 180 days to close on replacement property. You then can take your time to search out for leads for excellent below market buys. 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.

ALERT: While they are great vehicles of saving taxes and wealth accumulation, 1031 exchanges must be done right (dotting your i's and crossing your t's) under specified IRS regulations.

A disqualified exchange can cost you the deferred taxes, plus penalties and interest, totaling thousands. You therefore need to have a full service Qualified Intermediary company to do all of the proper exchange documents, ensure the exchange is done correctly and be safe in escrowing your exchange funds, along with good customer service. I can tell you from teaching 1031's all over the country and formerly having had an my own Qualified Intermediary company, there are a lot of unqualified companies screwing up exchanges including title companies (even the big ones).

Most do not give you 1031 technical advice and give terrible (or no) service and hit you with hidden charges. Moreover, there are many cases of escrow negligence or fraud where the investor's exchange funds have been permanently lost (ten's of thousands of dollars), plus the tax liabilities on the failed exchange as a result of not having the funds to purchase replacement property and complete the exchange.

One company that I STRONGLY recommend is CPA Exchange

Services (CESI) operated by one of the top real estate tax and 1031 specialists in the country, *Steven Venuti,* CPA, MS Taxation. You will receive highly competent ethical advice; total bonded safety of your funds (not one penny has been lost in their 15 years in business); no hidden charges; great customer service. CESI does exchanges, nationwide. You can call Steve for a no-pressure free initial phone consultation at 1-800-351-1031. You will not go wrong. Please mention "Al Aiello".

14.

TAX-FREE WEALTH WITH SELF-DIRECTED IRA'S

Another Way to Sell Properties Tax-Free

What is a Self-Directed IRA?

A self-directed IRA (SDIRA) is just like any other IRA (regular or Roth), except that *you* decide where to invest the funds, as opposed to some institution (such as a bank or brokerage firm). You have more control over your own investment. Along with a third party custodian, you initiate the investment decisions when you want to buy and sell property using an SDIRA. Understand that financial institutions (such as a bank or brokerage firm) do *not* have this type of SDIRA. You must use a third party custodian who does the paperwork to enable the SDIRA to make the transaction. One such company (very reputable) is

National Association of Financial & Estate Planning (NAFEP). Ask for

Scott Janko, 801-266-9900 x125, scott@nafep.com

SDIRA's pertain to all retirement plans - Traditional IRA's, Roth IRA's, SEP plans, Simple plans and Qualified Plans. So when I say "IRA" or "SDIRA" I mean these plans too.

Flip Your Properties Tax-Free

Once you avoid being a dealer (per Ch, 12), another vehicle I like for avoiding taxes on gains is the SDIRA, especially for quick flips. That is, quickly sell properties (or options) in a SDIRA where the profits go right into the IRA and are consequently not taxed.

As a result you can amass thousands of family wealth with total exponential tax-free compounding. While there are limits on contributions to retirement plans, there are no limits as to the amount of profits in an IRA,

The largest profit I have seen is when my student, Adam, made 1.5 million dollars on the wholesale assignment of an agreement from the tax-free seller (Adam) to the buyer via the SDIRA. The 1.5 million dollars went right into the tax-free haven of Adam's SDIRA, along with huge exponential tax-free compounding.

If a Roth IRA [including a 401(k) Roth] the profits will become, not just tax deferred, but truly totally and permanently tax and penalty free*. Over time this could amount to tens of thousands, even millions (as we have just seen on one deal!) What a great college fund *without* costly annoying student loans that later come back to haunt you!!

*How Roth distributions qualify as totally tax and penalty free: Qualified distributions from a Roth IRA are *not* taxable or subject to the 10% penalty on early withdrawals, provided these two tests are met:

(1) Qualified distributions cannot be made until five (5) years has expired since the first tax year that you made the first contribution to the Roth IRA and (2) The distribution must be made on or *after* you reach 59-1/2, or if under 59-1/2 because of death, disability or for first-time home-buyer expenses. Note that the contribution portion of a Roth (your own contributions) can be taken out of the IRA tax-free at any time.

Once you meet the above tests you can take out your real estate profits permanently tax and penalty free!

You Generally Should Not Use a SDIRA to Purchase Leveraged Rental Property as a Keeper

Reason: We have seen leveraged property with large interest deductions, huge componentizing deductions and other deductions create significant paper tax losses. But these property tax losses are useless in an IRA because the IRA, as a tax exempt trust, already shelters income. You would be putting one tax shelter (real estate) into another shelter (an IRA). You therefore would not be able to use the property losses to offset your other income including creating NOL's (ch 11). You would end up losing thousands of savings. Moreover, if your IRA purchases real estate with a recourse mortgage (where you are personally liable), there are costly penalties. If the property has a non-recourse mortgage (where you are not personally liable), there are less severe consequences, but it still does not make "tax" sense as per the above. Moreover non-recourse mortgages (where you are not personally liable) are more difficult to get.

Note: The above rules for mortgaged property acquisitions in a retirement plan pertain to traditional IRA's, Roth IRA's, SEP plans, Simple plans and Qualified Plans.

Your SDIRA Can Purchase "Cash Cow" Keepers

The only types of keepers your SDIRA could purchase, that makes tax sense and would not cause mortgage related penalties, are what I call "cash cows". These are properties purchased all cash with no financing (no mortgage payments) and typically done so at a low price along with high rental income. This *low price-high income* combination, along with no mortgage payments, often equates to taxable cash flow income, even after componentizing deductions.

Many times this taxable cash flow income is substantial, and with rent increases, could even be more so over time. In a SDIRA all of this cash flow income can be totally sheltered from taxes. If the property is sold at a profit, the profit is also totally sheltered from taxes (because the property is already is in the IRA).

But your SDIRA must have enough cash to purchase the property. You, yourself, cannot partner with your own SDIRA to make the purchase. This would be a prohibited self-dealing transaction causing substantial penalties. You also can not use recourse financing as discussed above. However, your SDIRA can partner with a qualified unrelated party, or their SDIRA. Related/qualified and unrelated/disqualified parties are defined below.

Borrowing from an IRA-Disqualified Parties-Qualified Parties

Borrowing from your own IRA or that of a disqualified (related) person will cause the IRA to be taxed as ordinary income for the amount of the borrowing and where applicable a 10% penalty. The same would apply if the IRA was pledged or used as security for a loan. IRC 408(e)(3). These prohibited (self-dealing) borrowing transactions apply to traditional IRA's, Roth IRA's, SEP plans and Simple plans.

However you can borrow funds from the IRA of a person who is not disqualified (or unrelated).

Related or disqualified parties. But first the following are *related* or *disqualified parties* whose IRA you cann<u>ot</u> borrow from or do any transactions with:

_You (the IRA owner); those who makes decisions for the plan; those who provide services to the plan, members of your lineal family such as spouse, ancestors, direct descendants (parents, grandparents, children, grandchildren), and any spouse of a direct descendant (parents, grandparents, children, grandchildren and even in-laws). .

_ Also disqualified related parties are corporations, partnerships, LLC's, trusts, or estates in which you or any of the above lineal family members own, directly or constructively*, at least 50% of. Thus, 49% ownership or less of non-constructive ownerships is OK. IRS Publication 590.

*<u>Alert on "constructively"</u>: Any entity ownership by a *related party* also counts as your ownership. For example, you personally own 49% of a real estate LLC-partnership and your spouse (or other lineal descendent) owns the other 51%. You are considered to "constructively" own 100% (or over 50%). That is, you have 100% constructive ownership. Thus, any transactions your IRA does with this LLC-partnership are prohibited (or self-dealing).

<u>Non-related qualifying parties are</u>: Brothers, sisters, aunts, uncles, nieces, nephews, cousins, friends, business associates and *less than* 50% non-constructively owned entities. Therefore their IRA *can* do business with you including lending you money and vice versa. IRS Publication 590.

Two borrowing strategies...

1. You *can* borrow money from the IRA's and other retirement plans of the above non-related parties.

2. Unlike your IRA, you can borrow from your own qualified (Keogh) plan such as a profit sharing or pension plan, if the plan has a provision for such borrowing. These plans can also be pledged as security for a loan. Such borrowing and pledging are subject to special rules and dollar limitations. Check with competent tax counsel or refer to the resource section in the back of this publication.

Three final pointers about borrowing...

1. Borrowing from an IRA must be done with a self-directed IRA (SDIRA). along with a third party custodian, as previously discussed.

2. Another excellent source of borrowing, unrelated to IRA's, is the *Zero Interest Loan Program*. For more details go to www.goldminevipaccess.com.

to the green banner; and/or call Dave Candle at 412-453-4199. Please mention "AL Aiello" so they know what's going on.

3. Unrelated to IRA's, if you are borrowing for the down payment to purchase

property, the mortgage lender may not permit you to borrow down payment funds at least at a time proximate to the loan. So if you are going to borrow, do so as soon as possible, or just somehow come under lender guidelines.

15.

RENTING/SELLING VIA LEASE-OPTIONS

Great Investment and Tax Advantages

A *lease-option* (or rent-to-own) is where the option to purchase the property is combined with leasing the property. So here you have a "tenant-buyer" (or more accurately the "tenant-optionee") who rents the property from you (the owner-optionor) along with an option to purchase the property from you (the owner/optionor). Lease-options have the following *investment* advantages:

- Less vacancies, because the tenant- optionee usually stays longer with the rent-to-own arrangement. Fewer vacancies mean much less turnover costs and more cash flow.

- Less maintenance, because the tenant- optionee acts and thinks like a homeowner, they have more pride of ownership and therefore take better care of the property. In some rent-to-own arrangements, you can even make them more responsible for minor maintenance and repairs. This equals more cash flow.

- More cash flow from option monies, because typically the tenant-optionee pays you additional for the option-to-buy by way of option money, either upfront or monthly, or both.

- Higher selling price with no commissions, because typically the tenant-optionee will pay market price and without real estate commissions (which can be substantial). Again, more cash for you.

Lease-options have the following *tax* benefits for you, the owner-optionor:

- Tax-deferred deposits. Upfront option deposits are tax deferred until they lapse or are exercised by the tenant buyer. Regulation 1.1234-1(b).

<u>Such option payments in the form of cash are still tax deferred even if the owner-optionor does not have to escrow the money or restrict it in any way and has full use of the funds</u>. Here, you can immediately use the

tax-deferred cash to reap yields from other investments.

- Tax-deferred payments. Like the upfront deposit, any monthly option payments are tax deferred, yet you still can claim all property deductions including depreciation. Regulation 1.1234-1(b). (A great double-play combination of tax deferred income on one end, and full tax deductions on the other end).

- Sell property tax-free to the tenant-optionee. Upon the exercise of the option, you can convert the lease-option into a 1031 tax-free exchange, including option deposits not being taxed.

Bottom line...You profit much more with lease-options.

15-A.

TAX IMPACT OF SELLER FINANCING

Basic Rules of Installment Sale Reporting to Defer Capital Gains Taxes

---

What is “Installment Sale”?

Under IRC 453, *installment sale* results when a non-dealer\seller elects to defer taxes because they are holding at least part of the selling price as a mortgage (or deed of trust), instead of receiving all cash on the sale of their property. The seller will then subsequently receive payments on the mortgage. Because the receipt of cash is deferred, the capital gain taxes are also deferred and spread out over the period in which the installments are received (instead of being paid all in one year). In real estate jargon, installment sale is also referred to as a "s*eller takeback"," seller financing"," purchase money mortgage", or " paper"*.

Tax Advantages of Installment Sale Reporting

For *investors* (not *dealers*), installment sale defers the following types of tax liabilities:

(1) Federal capital gains tax

(2) Federal alternative minimum taxes (AMT)

(3) Generally, state income taxes (Check the laws of your own state).

*Tax Dis*advantages of Installment Sale Reporting

Installment sale does <u>not</u> defer the following types of tax liabilities:

(1) Taxes from depreciation recapture* under IRC 1245 and 1250

(2) Taxes from the gains of dealer property (see ch. 12)

(3) Taxes from the recapture of tax credits, such as the rehab tax credit for older or historic properties or low income housing credits

<u>Alert</u>: All of the above tax liabilities are <u>taxed in full, even if no cash is received</u>!

*What is *depreciation recapture*? When you sell property you must reduce the property basis by the amount of depreciation allowed or allowable. This in effect increases the taxable gain. But this is not depreciation recapture in the technical meaning of the word. *Depreciation recapture* is the part of the realized gain that is *not* taxed as capital gain, but instead taxed as ordinary gain, IRC 1250; 1RC 1245. The remaining part of the total gain is then taxed as capital gain. On the sale or disposition of investment (non-dealer) property, depreciation recapture generally originates from taking accelerated depreciation or from holding the property a year or less.

Accordingly, many sales or dispositions will not have depreciation recapture in the true sense of the word; but there will be those that will. Note that the portion of the long-term capital gain that is attributable to all real property *straight-line* depreciation is taxed at a top rate of 25%. <u>This is not depreciation recapture in the true technical definition of the term</u>. Again "depreciation recapture" will generally result from taking an accelerated method of depreciation or from holding the property a year or less. When you see or hear the term "depreciation recapture", think of <u>ordinary income</u> taxed at higher rates.

Other tax disadvantages of installment sale reporting

- A final balloon payment on the note will trigger the remainder of the taxes due (without the ability to do a 1031 exchange).

- The interest portion of the mortgage payments is fully taxed as ordinary income.

How to Compute Gain via Installment Sale

With installment sale reporting, a certain "profit" percentage of the down payment and principal payments are recognized as taxable gain.

This percentage is called a "Gross Profit Ratio", which is based on the gross profit (or realized gain) divided by the contract price (which is usually the total selling price).

EXAMPLE: If the selling contract price is $100,000 and the realized gain from the sale is $60,000, the gross profit ratio is 60% ($60,000/$100,000). Assume in the first year the buyer puts down $19,000 and pays another $1,000 in mortgage principal payments for total principal payments of $20,000. The taxable gain for the first year is $12,000 (60% GP ratio x $20,000 principal payments). To arrive at the capital gain tax liability you multiply the taxable gain of $12,000 times the applicable capital gains rate*.

* TAX ALERT ON 25% RATE: Installment sale As It Pertains To The Portion of Gain That is Straight-line Depreciation - The realized gain on the sale of real estate that pertains to straight-line depreciation is taxed at a maximum rate of 25% with the balance of long-term gain being taxed at the present lower capital gain rate (not counting alternative minimum tax or state taxes). With installment sale reporting, the gain from straight-line depreciation is taxed *first* at the 25%, with the remaining long term capital gain taxed at the present lower capital gains' rates. (*Taxpayers Relief Act of 1997*)

Note: The gain that pertains to straight-line depreciation is still entitled to tax deferral via installment sale, but is taxed at a higher federal capital gain rate of 25%. However, the gain that pertains to true "depreciation recapture" is *not* entitled to tax deferral via installment sale. That is the entire amount of such depreciation recapture is taxed in full as ordinary income even with installment sale reporting. (This is not so with a 1031 exchange) *Depreciation recapture*, in the true sense of the word, is defined at the beginning of this chapter.

Installment Sale Reporting – Other Various Issues

Imputed interest. The tax law requires a minimum amount of interest to be charged by the seller, otherwise the IRS has the right to impute interest, IRC 483; IRC 1274. The amount of interest required to be charged is based on the current Applicable Federal Rate (AFR) published at the beginning of each month in the Internal Revenue Bulletin.

IRS reporting form. Installment sale is elected and reported on IRS forms 6252 and Schedule D.

Should you elect installment sale with seller financing? There is the tax decision of whether to defer taxes via installment sale reporting (*elect* installment sale), or to report the entire installment gain in the year of sale (elect *out* of installment sale). This will depend on a number of factors such as your tax bracket at the time of the sale and the availability of deductions or loss carryovers to offset gains. A further discussion of this is beyond our scope. Seek competent tax advice.

Electing Out. If you want to elect out of installment sale, you can do so by *not* using Form 6252 and by reporting the entire gain (including the installment obligation), Reg. 15A.453-1(d)(2). If the property is land, use IRS Schedule D to report the entire gain. For depreciable rental or business-use property use IRS Form 4797 and Schedule D. Electing out must be done by the due date of the tax return, plus extensions, IRC 453(d)(1).

Revoking a late election to elect installment sale reporting, or revoking a late election to elect *out* of installment sale reporting.

This is difficult and calls for competent tax counsel.

The ideal use of seller financing\installment sale. Generally, installment sale reporting is ideal for someone who finds it more beneficial to take back financing (such as for a quicker sale or higher price); does not have the immediate need for the cash; and needs the tax deferral.

Complicated tax traps. There could be complex tax traps with installment sale reporting that could cause unexpected tax liabilities such as deprecation recapture (previously discussed), dealer status (ch 12), along with related party transactions, escrowing arrangements, subject-to mortgages, mortgage assumptions, selling the note, etc. With these issues, competent counsel should be sought.

Installment Sale vs. 1031 Exchanges

The part of the sales price that is toward the seller financing does not qualify for the 1031 exchange, because a mortgage note is *not* like-kind property. Only the cash portion of the sale can qualify for Section 1031 non-recognition treatment.

It is the author's opinion that a 1031 exchange is a superior way to defer taxes than installment sale reporting for several reasons:

(1) With installment sale, you still have to pay at least some taxes on the down payment. With a 1031 exchange you can totally defer all tax liabilities as discussed in Chapter 13.

(2) A final balloon payment on the note will trigger the remainder of the

taxes due as previously discussed. This will not happen with a 1031 exchange.

(3) The interest portion of the mortgage payments is usually a substantial amount and is fully taxed as ordinary income. On the other hand, cash flow generated from the ownership of the 1031 replacement property can be sheltered through depreciation deductions (esp. componentizing) and even create “paper” losses which in turn generate tax savings. All of this has been previously discussed and illustrated.

(4) With a 1031 there can be a *total* deferral of all tax liabilities (including deprecation recapture as previously defined) which could become permanent by continuing to exchange until death, at which time the taxes are completely eliminated with a step-up in the property’s basis to its fair market value as per IRC 1014.

(5) With a 1031 exchange, you can take out substantial tax-free cash via a refinance either before or after the exchange (but not during). Unlike selling an installment note at a discount, such cash out refinances are obviously not subject to such discounting.

Doing the 1031 exchange. When you are seeking favorable 1031 treatment, it is better to obtain from the sale as much cash as possible because the cash can be sheltered via a 1031 exchange while the installment note cannot. Here are some planning recommendations to receive more cash instead of a note:

(1) Negotiate for more cash - Try to negotiate for more cash instead of a note. As a concession to getting more cash, it may even pay to lower the price.

(2) Other sources of cash – You and/or the buyer look for other sources of cash financing such as a private investor, friend, relative, aggressive lender or self-directed IRA (SDIRA) of a party unrelated to the buyer (which could be your own SDIRA). Perhaps you could co-sign to assist in the financing, or lend the buyer the cash out of your own funds.

Positive Tax Result of Doing the Above. Instead of taking back financing via a note, the buyer has the cash available. The buyer could then come to the settlement table with all cash (instead of a note). All of the cash could then be placed into your 1031 exchange escrow account and qualify for a 1031 exchange to acquire replacement property. This equates to total tax deferral with the investment use of the savings.

1031 exchanges are further discussed in Chapter 13.

Note: The above discussion about seller financing/installment sale reporting is an overview of a much more comprehensive topic. Seek competent advice or refer to the resource section at the end of this publication.

16.

ENTITY SELECTION & STRUCTURING

Start Off With The Right Form of Ownership – Protect Yourself, Save taxes, Avoid IRS audits

---

For my real estate, which entity do I select – Corporation, LLC, LP, FLP, Trust? This is a proverbial (and important) question for the real estate investor. To accomplish the essential task of selecting the right entity read on.

Three-prong approach. First off, when you evaluate any form of ownership or entity, you should get the entire picture and use the 3-prong approach which is the three sides of an entity...

1. **TAX**

2. **IRS**

3. **LEGAL**

The fundaments of entity structuring are based on current factual data, not opinion. Yes, you could have an “opinion” about anything including entity structuring. But it’s really the *facts* that will determine a *logical conclusion* with a plan of action rather than just a blinded and perhaps costly opinion. The factual data is determined as follows:

1. TAX side comes from current tax law provisions (internal revenue code, regulations, tax court cases).

2. IRS side comes from published current audit statistics as to which forms of ownership are audited more or less.

3. LEGAL side comes from state law (statute or case law).

Pay particular attention to the TAX and IRS sides. Do this instead of just one side, such as the legal. While the legal is very important, most of the monetary benefits or detriments will generally come from the TAX and IRS sides. In the book titled “Asset Protection” (by Christopher Riser, Esquire) it is stated that most so called “Asset Protection Guru’s” know little or nothing about the TAX and IRS side of entity structuring and therefore teach complicated expensive structures without regard to current Tax/IRS considerations. As you will see, this can be very costly to your financial well being.

Many times, much of the money is made or lost much more on the tax side of entity structuring than the legal side. Despite the increase in law suits, there is still a much better chance that taxes (or an IRS audit) will drain your equity rather than a law suit. Without planning, taxes are a *killer*! Not only are they a large outlay, but a *frequent* one as well. If you are the typical taxpayer, every year from January 1 to about mid May (over four months), every dollar you earn goes to taxes. Law suits can hurt you, but not every year for over four months! Moreover, certain ownership forms are audited more than others. In this chapter we will evaluate which ones are. By no means am I diminishing the importance of legal protection. It’s just that you need to look at the *entire* picture.

So based on this 3-prong factual data approach, let’s do an overview of the following forms of ownership for <u>real estate investments</u>.

- Sole Proprietorship
- General partnership

- Limited Partnership (LP)
- Family Limited Partnership (FLP)
- S-Corporation
- C-Corporation
- Limited Liability Company (LLC)

NOTE: Because this is a tax publication, its focal point is on the tax and IRS sides of the entities. But the legal side will also be addressed.

Sole Proprietorship

(Just you, in your name)

1. TAX: **Good** - There is total pass-through with no double taxation or entity limitations in deducting tax losses.

2. IRS: **Bad** - Sole proprietorships file IRS Schedule C's or E's which are very highly audited. (IRS agents would rather audit Schedule C's or E's, than go to heaven!)

3. LEGAL: **Bad** – Total exposure, no privacy along with *total* personal liability.

Logical conclusion: AVOID, unless you want to deal with "demons" like the IRS, aggressive creditors and sue-happy lawyers.

General Partnership

(Two or more sole proprietors)

1. TAX: **Good** - There is total pass-through with no double taxation or entity limitations in deducting tax losses. As you will see, partnerships have better tax advantages than sole-proctorships.

2. IRS: **Good** - Partnerships file IRS Form 1065 which is audited much less than Schedule C's or E's and less than corporations.

3. LEGAL: **Bad** – You are jointly and severally liable on a personal basis. This means you are still liable even if you did nothing wrong, but your partner did. Plus, for a general partner's ownership interest, there is no charging order protection (discussed later).

Logical conclusion: Good tax and IRS; but no legal protection – AVOID*.

*<u>AA COMMENT</u>: Despite the risky legal side, I still think filing as a general partnership is better than a sole proprietorship because of the much lower IRS audit profile and better tax advantages. But there is a better choice of using a statutory entity that gives you legal protection, great tax benefits and a lower IRS audit profile. That entity is discussed later in this chapter.

Now we begin an overview of the state statutory entities which you would create as a separate legal entity in the state where you form the entity...

Limited Partnership (LP)

A limited partnership (or "LP") is a separate legal entity formed under state limited partnership statutes. All states have LP statutes.

An LP is distinguished from a general partnership, in that the limited partners are not personally liable for partnership debts beyond the amount of their contribution. But limited partners must remain passive and *not* take part in the control and management of the business. In an LP, you must have a general partner with at least a 1% ownership interest. The remaining 99% can be owned by the limited partners. (One person can be both a general and limited partner.)

1. TAX: Not good – If you operate your real estate out of an LP you are subject to passive loss limits (ch. 9) and cannot deduct property tax losses against your other income. This also includes using NOL's (ch. 11). Unlike members in an LLC, limited partners are totally subject to passive loss limits and are therefore *not* entitled to currently deduct rental property losses against other types of income. They cannot even come under the $25,000 loss exception. IRC 469(i)(6)(C); 469(h)(2). *Reason*: Most of the ownership of an LP is by the limited partner (or partners), typically 99%. By state statute a limited partner cannot participate in the company's business and management activities. They must remain passive. (If they do participate, they lose their limited liability protection). Thus, any and all limited partner passive losses must be suspended and carried forward until the partnership incurs passive income, which will generally be gain from the sale or disposition of property.

2. IRS: **Good with exceptions** – All partnerships file IRS Form 1065 which is audited much less than Schedule C's or E's and less than corporations. However, certain syndicated LP's and family limited partnerships (covered next) may have a higher audit profile.

3. LEGAL: **Good but complex** - Excellent limited liability protection for the limited partners including charging order protection, discussed below. But there is complexity with the legal side of an LP. There must be at least one general partner along with the limited partner(s). While the limited partner(s) have limited liability, the general partner, who runs the business, does not and is personally liable for all partnership debts & obligations. The way to insulate the general partner (and the partnership) from personal liability is for the general partner to become another entity such as an LLC or corporation. Thus you have two entities: (a) The limited partnership itself and (b) The LLC or corporation, as the general partner. This entails more set up costs and more annual costs. There is also the caution that must be exercised in that the limited partner(s) cannot actively participate in the company business or management.

Logical conclusion: Generally do not use except in states where there will be substantial franchise type taxes and the state taxes LLC's, but not LP's. At the present time this is only two states where this may occur – Pennsylvania and California. However, if the business shows little or no income or even a tax loss (such as with real estate), then even in these states, an LP will generally not be a good choice.

CHARGING ORDER

A charging order is an in-built shield because it's what's needed by a claimant in order to attach a limited partner's interest in an LP or member’s interest in an LLC. First off, a charging order is a judicial process, which will most likely require the services of a knowledgeable attorney (probably high priced). Secondly, even with the charging order, the judgment creditor does not have the right to force the sale of the company assets because they cannot make management decisions for the company. For the creditor it could even cause income tax liabilities without getting any cash. Accordingly most charging orders are never even initiated in the first place. What great protection! Charging order protection pertains to limited partnerships and family limited partnerships, but generally not corporations. A charging order also pertains to a two or more member LLC (namely an LLC-partnership), but in most states not to a single member LLC (discussed in ch.17).

Family Limited Partnership (FLP)

A family limited partnership (or “FLP”) is an LP except with family members, where typically the parents or other senior persons will be the general partners and the children or other heirs will be the limited partners.

1. TAX: Same bad news as with LP’s – Passive loss limitations as previously discussed above under LP’s. Many of my students, using the componentizing depreciation system, show large “paper” losses on their properties (see ch. 5). They love to deduct such losses against their other ordinary income, such as W-2 income, business income, gains, IRA

distributions, etc. They save thousands every year doing this. (Thousands they can reinvest for more income and more wealth). However, an FLP is a limited partnership and a limited partnership is subject to passive loss limitations. This means that such losses would not be currently deductible against your other income as per the above. You therefore lose the investment use of the tax savings.

2. IRS: High audit profile when used for reducing estate taxes (which is the only reason to use an FLP). FLP's have recently become subjected to frontal attacks by the IRS with heavy litigation in numerous tax court cases over the validity of the FLP entity and valuation discounts on gifts of FLP units to younger family members in order to reduce estate taxes.

[NOTE - IRS ATTACK ON FLP'S: Partnership tax returns (form 1065) are generally audited less, which is one reason (among many) why I recommend partnerships for real estate. So if FLP's file IRS form 1065, then why are they a hot audit item? With the audit of FLP's what happens is that the gift tax return (form 709) is audited first. It's this return (709) that reports the gifts of the FLP units to younger family members, at deep valuation discounts, in order to reduce estate taxes. The audit of the gift tax return (form 709) then leads to the audit of the FLP return (1065) so the IRS can determine if the FLP is structured as a valid business entity and if not, disallow or reduce the valuation discounts and collect more estate taxes.]

3. LEGAL: **The same as an LP** - excellent limited liability protection (including charging order protection). But FLP's are complex legal and tax entities. They therefore require careful draftsmanship by qualified professionals of the pertinent documents and implementation of the proper procedures for the devaluation and gifting of LP units to younger family members (not do-it-yourself kits).

Logical conclusion: The primary reason for using FLP's is for asset protection? NO! Promoters who sell expensive FLP kits would like you to believe this. Only consider FLP's for large taxable estates to reduce estate taxes but only with competent legal and tax professionals. Otherwise do not use FLP's. Moreover, besides FLP's, there are much lesser audit-prone (superior) alternatives to reduce estate taxes and that also give asset protection such as certain trusts, like a private annuity trust (PAT), discussed in Chapter 18. Outside of estate tax reduction, LLC-partnerships, with a very low audit profile, could protect you as well as an FLP, along with avoiding costly passive loss limitations. (LLC's are discussed later). In short, FLP's are overrated and IRS hated!

S-Corporation

All corporations start as a C-Corporation, but may make a written and timely tax election (IRS form 2553) to be classified as an S-corporation. The "S" is a federal "tax" status of the corporation which is governed by SubChapter S of the Internal Revenue Code. Unlike C-Corporations,

S-corps do not have their own tax rate schedule and usually do not pay their own corporate taxes. Instead, income and losses (but within certain limits) pass through to the shareholder's individual tax returns, via a shareholder K-1 schedule.

1. TAX: Bad & many - There are over 20 S-corp tax disadvantages for real estate ownership. Here are a few of them:

W-2 earned income. You must receive a salary from an S-corp because you are an employee of your own corporation (unlike LLC-partnerships, which are flow-thru entities with no salary requirements). Paying salaries means "garbage" employment taxes & payroll filings; highly taxed W-2* ordinary earned income, along with IRS controversy as to how much salary should be paid (IRS wants a lot paid to you).

***WHY WOULD YOU WANT TO CREATE UNNECESSARY HIGHLY-TAXED EARNED INCOME?**

One of the great benefits of real estate investing is to get way from Just-Over-Broke W-2 income and reap the passive income of real estate which not only is taxed less, but also can be totally sheltered with property deductions and even converted into paper tax losses with componentizing deductions!

Limits on deducting tax losses against your other income. S-corps are not total pass-through entities like LLC's. When the S-corp owns leveraged real estate, there are limitations on deducting property tax losses against other income, because tax losses (such as rental property losses) are limited to the shareholder's basis in the S-corporation's stock, which does not include third party debt, such as a mortgage, IRC 1366(d). Such basis only includes the monies invested by the shareholders' themselves (such as a down payment for real estate). This could be a significant pitfall for leveraged real estate showing considerable tax losses.

Taxation of normally tax-free borrowed money. Watch this one! If you (individually or through an LLC) do a cashout refinance and pocket the money, this borrowed money is tax-free. But if a cashout refinance is done through an S-corp which then distributes the funds to you, this could be a taxable distribution. Yes, normally tax-free borrowed money becomes taxable! IRC 1368(b).

Dealer. When used for resale property ("flips"), the S-corp causes you to be a dealer because S-corps are for active (ordinary income) businesses. Therefore, using an S-corp for flips (a "dealer" entity) is a blatant admission of costly dealer status and impairs total dealer-avoidance planning, discussed in Chapter 12.

More! There are even more S-corp pitfalls for real estate. But the above should be enough to convince you that using an S-corp for real estate will give you absolute "tax indigestion"!

2. IRS: Bad -Audits of IRS form 1120S have increased substantially over recent years, mainly over issues of reasonable compensation. Remember you must receive a salary from an S-corp because you are an employee of your own corporation; and IRS wants your S-corp to pay you a lot of this highly taxed W-2 income along with employment taxes.

3. LEGAL: Good - Limited liability for shareholders. However, corporations, in just about all states, **do not give you charging order protection**, previously discussed.

Logical conclusion: By now hopefully you are convinced that the very logical conclusion is not to use an S-corp for real estate, both for keepers and quick sale properties (flippers). The sole & only purpose of using an S-corp is for small profitable businesses (not involving real estate ownership) to reduce Social Security\employment taxes; again NOT real estate!

C-Corporation

All corporations start out as *C-corporations*. The "C" is a federal "tax" status of the corporation which is governed by SubChapter C of the Internal Revenue Code, which states that all income and losses of a C-corporation stay within the corporation. A C-corporation has its own tax rate schedule and pays its own corporate taxes.

1. TAX: Bad & many – Like S-corps there are over 20 C-corp tax disadvantages for real estate ownership. Here are a few of them:

No pass-through of losses. With a C-corp, tax losses do not at all pass through to the owners, but are locked within the corporation. This could equate to the loss of significant tax savings.

Many others. C-corps have many other tax pitfalls for real estate such as: Double taxation on net profits, no lower capital gains rates, higher deprecation recapture, state corporate taxes, payroll taxes & filings from paying you W-2 salaries, taxation of distributed property when the appreciated property is titled from the corporation into your name. And there are more too numerous to mention. The above should be enough to convince you > that using a C-corp., as a primary holding entity for real estate, will give you the same *tax indigestion* as an S-corporation.

2. IRS: Moderate exposure - IRS form 1120 is audited less than schedule C's & E's and generally less than S-corporations 1120S, but audited more than partnership form 1065.

3. LEGAL: Good - Limited liability for shareholders. However, corporations, in just about all states **do not give you charging order protection**, previously discussed.

Logical conclusion: Do not use a C-corporation as a primary entity for holding real estate, both for keepers and quick sale properties (flippers). C-corporations have excellent tax advantages (including deductible/tax-free fringe benefits) for highly profitable businesses not involving real estate ownership.

<u>Asset Protection Strategy For Corporations to Get Charging Order Protection</u>: Do the legal formation of an LLC but elect the LLC to be taxed as a corporation. Understand that, as a legal entity, an LLC can be *taxed* as sole proprietor, or as a partnership, or as a corporation. If you want a corporation (S or C) because it fits your *tax* needs (such as for a business not involving real estate ownership), do the *legal* formation of a two or more member LLC (not single-member) and then elect the LLC to be *taxed* as a corporation, filing IRS form 8832. *Reason*: On the legal side, unlike shares of a corporation, a membership interest in an LLC gets charging order protection (previously discussed). Plus, LLC's are less legally complicated than corporations.

Limited Liability Company (LLC)

An LLC is an unincorporated business entity filed under state law, in which all owners (called "members") have limited legal liability. It is a hybrid entity that combines the major legal advantages of corporations and the excellent tax advantages of general partnerships. The owners in an LLC are called members or managers. The first LLC law in the United States was enacted in 1977 in Wyoming. Today all 50 states and the District of Columbia have enacted LLC statutes. They are here to stay.

The ideal entity for real estate is not just an LLC but an LLC-Partnership. That is, on the legal side, you form the LLC for limited liability protection. On the tax side, you elect (on IRS form 8832) that the LLC be taxed as a partnership giving your real estate business the favorable benefits of partnership tax law including a lower IRS audit profile. *Result*: You have on the legal side, an LLC; and on the tax side, a partnership = one entity = an LLC-Partnership. (This partnership format is discussed later in this chapter).

1. TAX: Superb. As a separate legal entity, an LLC can be taxed as a sole proprietor, as a partnership or as a corporation. But for real estate ownership, an LLC should elect to be taxed as a partnership where it has the best tax advantages of a *pure flow-through* partnership as follows:

NO highly taxed W-2 income. Unlike corporations, LLC-partnerships do not have to pay salaries to partners and thus avoid payroll recordkeeping, tax withholdings and filings. There is no unnecessary highly taxable W-2 income and no unnecessary controversy with IRS. Optionally and without the bookkeeping of W-2 salaries, simple *guaranteed payments** could be paid to members to create earned income for valuable retirement plan contributions.

*Optional Guaranteed Payments - If a member/partner needs earned income for the basis of making retirement plan contributions, the partners could receive such earned income <u>without W-2 salaries</u>. Here the partnership could pay a "guaranteed payment" (deductible by the partnership) which is earned income to the partner and the basis for making retirement plan contributions. A guaranteed payment is a deductible straight fee for specific services rendered by the partner to the partnership in their capacity of a partner (like a 1099 payment but with no 1099 required). It is not paid as a salary via a W-2. IRC 707(c). Thus, <u>payroll reports do not have to be prepared and filed</u>. However to the partner, a guaranteed payment is subject to Social Security taxes. But again, the guaranteed payment is earned income and the basis for making valuable retirement plan contributions. For instance, only a $10,000 guaranteed payment is sufficient earned income to create $15,000 of retirement plan contributions (which would be $5,000 to an IRA and $10,000 to a Simple Plan, with just the $10,000 in earned income). Guaranteed payments are optional and not required as with corporate salaries. What a winner!

There are no corporation limits for deducting property tax losses. Even S-corps have limits on deducting losses with leveraged real estate as previously discussed.

Sidestep passive loss limitations. Unlike limited partners, because LLC members can participate in management, they can bypass passive loss limits and fully deduct property tax losses against other ordinary income by actively or materially participating in company business and management activities under IRC 469.

No taxation of borrowed money. Unlike corporations, distribution of funds (including borrowed money) from an LLC to its members will not at all result in a taxable event.

No taxation of distributed property. Unlike corporations, there is no gain recognized to a member upon the distribution of LLC property to the member, even if it is appreciated property (with built-in gains) where the value is higher than its adjusted basis.

More! On the tax side, there are many other LLC advantages.

2. IRS: Low audit profile. By filing as a partnership there is lower IRS audit risk than other forms of ownership such as sole proprietorships and corporations. There is no IRS controversy on corporate tax-prone issues of "reasonable compensation" or "constructive dividends". There are no IRS issues of loans to partners as taxable dividends or salaries (as with corporations).

3. LEGAL: Excellent/less complicated. LLC's have the corporate characteristic of limited liability for *all* of the owners (members). The members of LLC-partnerships also receive charging order protection previously discussed. An LLC does not need an individual or entity (such as a general partner) who is personally liable for debts. NO LLC

member is personally liable. This is unlike a limited partnership, where there must be at least one general partner personally liable for all debts. This causes the necessity of additional cost and paperwork to incorporate the general partner. This is not necessary with an LLC. Unlike a limited partner, any LLC member can exercise control over daily business and management decisions without the fear or actuality of losing their protected, limited liability status.

LLC's are free from the qualification constraints imposed on S-corps. The members can be corporations, partnerships, estates, pension plans, IRA's, and non-resident aliens. Unlike S-corps, an LLC can have more than one class of "membership interest" (similar to stock).

A criticism of LLC's. Because they are relatively new in the US, they have not been as tested with actual legal disputes as corporations or limited partnerships. However, it was determined by one of the IRS's own attorneys that even the IRS could not force the liquidation of an LLC. Understand that the LLC statutes of all 50 states and the District of Columbia all recognize LLC's as legal entities separate and distinct from its member-owners. These statutes also grant the *corporate* shield of limited liability for its member-owners. This limited liability shield of LLC's is based primarily on corporation law which has many decades of long standing precedent in the United States. Properly structured, along with the appropriate entity formalities, LLC's give limited liability. Moreover, LLC's have now been in the US for over 31 years and are here to stay. Not that new anymore!

Logical conclusion: For real estate – LLC's have the best of all worlds, unlike any other entity:

- All of the legal benefits of a corporation including the corporate shield of limited liability for *all* of the owners

- The charging order protection of an LP, yet avoid the tax disadvantages of LP's, FLP's as well as S-corps and C-corps.

- All of the optimum tax advantages of a general partnership; yet avoid the legal disadvantages of a general partnership

- Control over management decisions for *all* of the owners, unlike limited partners in an LP

- Avoid the legal complications of LP's, FLP's and legal constraints of S-corps.

So in summary, for your properties you want an LLC-Partnership.

17.

SINGLE-MEMBER LLC'S

Beware of Legal & IRS Pitfalls

A single member LLC (SMLLC) is an LLC with one member.

1. TAX: Good - There is total pass-through with no double taxation or entity limitations in deducting tax losses.

2. IRS: Bad – SMLLC's are disregarded for tax purposes. Therefore, like sole-proprietorships, single member LLC's file Schedule C or Schedule E, which are very IRS audit-prone schedules. On the other hand, a two or member LLC files a partnership return (form 1065) which is less audit prone than Schedule C or E.

3. LEGAL: Not too good - While there may be a degree of asset protection, with the single-member arrangement, the creditor will find it considerably easier to successfully pursue a veil piercing claim and deemed that it legally does not exist. This would subject the company's

owner to unlimited personal liability for debts or torts of the company. The other legal drawback is, in most states, single-member LLC's do not get charging order protection, previously discussed in ch. 16. In most states a charging order only pertains to a two or more member LLC, namely an LLC-partnership, not a single member LLC.

Logical conclusion: Do not use SMLLC's. A two (or more) member LLC-partnership avoids the legal and tax drawbacks of single member LLC's. While the existence of other owners may not totally defeat a creditor's claim it certainly can weaken it, and with LLC charging order protection it can do so considerably. Plus there are the excellent tax advantages of partnerships for real estate including a lower IRS audit profile.

Need a partner to create the partnership?

If you operate as one person and not as a partnership, finding other persons or entities to be additional owners is not difficult. Another member (or members) could be your spouse, other family members or another entity that you own such as a trust, another LLC or a C-corporation. For example, your C-corp could be a 5% minority LLC member with you as the other majority member. Not only does this create the "partnership" entity, but also can generate additional C-corporation fringe benefit deductions yet without the corporate tax pitfalls, because the C-corp is a minority member. Another member could be a partner who adds value. So you can maintain control, these other partners can have small percentages of ownership and/or be non-voting members with no say in management. You do not have to have the additional member on the property deed; you can just add them as a member by way of the LLC operating agreement. This can be done after you acquire the property.

<u>Note</u>: The aforementioned entity structuring discussion focused much on the tax and IRS sides. As far as more on the legal side, see below.

no typo - *unlimited*)

* Legal Protection/ Defense for Lawsuits and Traffic Violations (this could also save you thousands!)

* Member Discount of a Guaranteed 25% For All Other Legal Services (try to get that from most lawyers!)

* Have your Will prepared or updated free of charge (it's a financial disaster without one!)

ALL THIS AND MORE CAN BE YOURS FOR

AS LOW AS $26 PER MONTH!!

(ONLY QUALIFY LAW FIRMS AR USED)

More Info: go to www.prepaidlegal.com/hub/janinepratt

or email us at IsuJaninepratt@aol.com or call at 215-271-1998

<u>18</u>.

OVERALL USE OF TRUSTS

A Way to Avoid Probate and Give You Privacy Protection

Land Trusts

Privacy. Property can be titled in a land trust which is a real estate trust that gives *asset privacy* because the title to the property is not held in the investor's name, but held in the name of a "trustee".

Investor control. The investor is the *beneficiary* and equitable owner of the trust's assets and thus retains control and management of the property.

Need a friendly trustee. The trustee, who holds legal title to the property, could be a trusted friend, your attorney or an institution such as a title company. This could vary state-wide (Choose your trustee carefully).

No LLC limited liability. Although a land trust may give privacy by "masking" ownership, it is not a separate legal entity that will give you corporate limited liability the way an LLC does.

But a land trust can be combined with an LLC where the LLC can be a beneficiary of the land trust. If the beneficiary of the land trust is an LLC instead of you personally, then the land trust\LLC combination should insulate you even further with more privacy.

Land trusts are not separate tax entities. They are tax-neutral grantor trusts, meaning there are no tax implications, favorable or unfavorable. With an LLC-partnership as the beneficiary\owner, the LLC reports income, losses and deductions on the LLC-partnership return (form 1065).

Estate Planning Trusts

For more privacy and to avoid probate, use estate planning trusts to hold legal title to the following assets:

1. Tangible Personal Property: Your vehicles (cars, trucks); personal valuables such as furniture, antiques, jewelry, art collection, coin collection, record collection, etc.

2. Intangible Personal Property: Ownership interests (shares) of your entities (LLC's, LP's, corporations); savings & investment assets (bank accounts, CD's, stocks, notes).

3. Personal-Use Real Property: Such as your home, second home.

4. <u>Not</u> Title to Investment Real Estate (Except Land Trusts): Trusts should not be used to directly hold title to investment real estate, except for land trusts as per the above. Instead your LLC should hold ownership of the property as previously discussed.

Chain of ownership. The way the chain of ownership works is that the LLC entity owns the real estate, not you. What you own are the units (or shares or certificates) of the LLC, which you can transfer to an estate planning trust, see next.

Types of Estate Planning Trusts. There are several types of estate planning trusts. Three of them are: (1) A revocable living trust (RLT), (2) a life estate trust and (3) a private annuity trust (PAT).

(1) RLT has several beneficial functions - Avoid the time and expense of probating a will; asset management during grantor incapacitation; and transferring the estate to the rightful heirs. The grantor can always amend or terminate a living trust with little or no adverse consequences. An RLT with a trustee other than the grantor could give some privacy. But while it may give some privacy, an RLT is really not a tool of asset protection because it is not a separate entity; it's an arrangement. See next.

(2) Life Estate Trust is a separate entity acting as a special family trust giving you total privacy; protecting your personal assets from lawsuits, lawyers, probate, public-exposure, divorce, and other eradicators of your wealth. This Nevada trust is superior to a revocable living trust as not only does it have all of the benefits of a RLT (avoid probate, etc.); but

also protects your personal assets. Nevada has very favorable trust laws for protecting and privatizing your personal assets.

(3) Private Annuity Trust (PAT) is an excellent vehicle for large taxable estates to reduce estate taxes, as well as all of the benefits of a life estate trust, including avoiding probate and asset protection.

A foremost expert on trusts (including the life estate trust and PAT) is Ron Noll, CPA, MST. Ron (or his son, Bill Noll, Esq.) can be reached at 1-800-360-6655. Tell Ron or Bill "Al Aiello" referred you so he will you give the best of attention.

RESOURCES – WHERE TO GET MORE INFO ABOUT AL AIELLO HOME STUDY COURSES

The content of this publication are excerpts from the much more comprehensive , a home study course *The Real Estate Investor's Goldmine of Brilliant Tax Strategies* by Albert Aiello

The Goldmine extensively covers the Tax Reduction Planning and IRS Audit-Proofing for all kinds of real estate investing:

- Rental property - small & large
- Commercial property - small & large
- Wholesale flips, assignments, subject-to's
- Rehabs, foreclosures, short sales
- Paper, notes, mortgage
- Seller financing, land contacts, wrap-mortgages
- Entity selection & structuring
- Selling properties tax-free
- Much More!

Written by an investor for all investors -- veterans, beginners, part-time, full time.

Included with this one-of-a kind program:

The Goldmine Manual - This updated Multi-Reference Manual of 250 pages includes the most exhaustive research covering dynamic tax strategies for all types of real estate investments; written in plain language.

The Goldmine 10 Audio CD's - You get 15 hours of instruction on 10 audio CD's. Get hundreds of strategies in easy to understand ways. CD's also make references to specific chapters in the *Goldmine* manual making it easy for you.

The Goldmine CD-ROM Forms Disk - Includes *23 Tax Reduction & IRS Audit-Proofing Forms* (you will not find anywhere else) for the complete componentizing system; to sidestep passive loss limitations; reduce taxes on property sales; IRS audit-proofing; 10 special reports; research appendixes w\complete tax cites and precedent. See below for more...

ON DISK - *The Goldmine's Tax Reduction & Audit-Proofing Forms*:

The *Goldmine* DISK contains 23 *Tax-Reduction And Audit Proofing* forms that implement and fully document the *Goldmine* strategies. You will not find these anywhere else!

* Forms To Substantially Maximize Depreciation Deductions Via Cost Segregation Analysis: Double and triple your depreciation deductions with detailed forms that include over 70 documented personal property items that can be depreciated over 5 years, accelerated, rather than 27-1/2 or 39 years, straight-line. 20 more items than can be depreciated over 15 years, using accelerated methods. Other special forms will enable you to fully write-off the building much faster than 27-1/2 or 39 years. Includes a case study with filled-in forms and instructions.

* Forms To Maximize Tax Savings -- Repairs Vs. Improvements: Put huge savings in your pocket by legally writing-off large capital improvements as fully deductible repairs with special forms that include over 70 documented deductible repairs, with tax law citations for *each* item.

Includes a case study with filled-in forms and instructions.

Save $1,000's in Consulting Fees! With these forms you do NOT need to hire a cost segregation consultant who would charge $5,000 to $10,000 or more and still not be as thorough as AL's system!

* Forms To Bypass Passive Loss Limits So You Can Fully Deduct Unlimited Property Tax Losses Against Your Other Income: Documents over 90 activities to prove your business & management activities so you are no longer subject to passive loss limits and will be able to deduct any amount of rental losses (over $25,000), no matter how large, regardless of the size of your income (even over $150,000 AGI).

* Forms To Reduce Or Eliminate Taxes On Property Sales: Pay little or no taxes when you sell your property, even if profits are huge.

* Forms To Reduce Or Eliminate Your Chances Of An IRS Audit: A prime rule of tax planning is not to get audited in the first place. These special forms will keep you out of the audit pile and save you taxes, penalties, interest legal fees time, and aggravation of an IRS audit.

* Plus 10 Special Tax Reports – Foreclosures, rehabbing, selecting a CPA, homeowner exclusions, deducting real estate cruises, self-directed IRA;s, show tax losses yet still get loans and more.

The Hundreds of Strategies in This Course Is Fully Backed-Up by an Arsenal of Tax Law Cites and Decades of Precedent In Understandable Language

Total Customer Support Program

You get a V.I.P. Membership which is exclusive for Al Aiello Goldmine students only,...

_Email Access Directly to AL for your tax questions, responded by Al with prompt expert results - save $1,000's in taxes and legal/accounting fees!

_Access To A Network Of Experts In Their Fields – Save time and money!

_Access For Your Tax Advisor's Use On Your Behalf (Including The 6 Red-Flag Indicators Of The *Wrong* Tax Advisor - Which could cost you big time!)

PLUS > Free Member-Only Web Site: A great resource you will not find anywhere else that focuses on tax-reduction, IRS audit-proofing and asset protection targeted for real estate investors. Includes: Updates every month with money saving ideas; informative cutting edge articles every month; FAQ's on 14 different topics with real world questions with Al's money-saving solutions; links to other great web sites. You will love it!

Al Aiello is Considered The Number One Speaker On Real Estate Tax

Strategies in The Country.... Jeffrey Taylor Founder, MrLandlord.com.

For more about the Goldmine home study course, including documented testimonials and how to order, click to...

www.REINFO.com

Or call 215-271-1998

THANK YOU!

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!