Tax Strategies for Real Estate Investors

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TAX STRATEGIES FOR REAL ESTATE INVESTORS - SPECIAL REPORT

Introduction

As a real estate investor you will make a lot of money. The biggest assault on your wealth accumulation will be taxation. Therefore, we want to make sure you don't pay unnecessary taxes. In fact, we want to show you that you are in control of how much tax you pay. You will find that you have the power to elect how much tax you pay as well as the power to grow wealth faster than you ever dreamed possible. How? It comes down to marrying your investment intelligence (your ability to generate a high rate of return) and the realization that as a real estate investor, you have many tax deduction and tax minimization strategies you can use to pay less in taxes than if you made the same money at a job.

In this special report we are going to tell you about some incredible strategies to help you minimize or even ELIMINATE your taxes on the money generated from your real estate activities! But first, we want to give you a frame of reference so that you can see just how devastating taxes can be. In our experience, investors sometimes underestimate the effect taxes have on their ability to create wealth. Often investors focus on doing deals and ignore the tax issues. It is a huge mistake that we want you to avoid.

The Devastating Effects of Taxation

If you had a dollar today and you were able to double it every day, in just 21 days your dollar would have turned into one million dollars. Isn't that stunning? In your wildest imagination could you have thought that there was anything you could do to turn one dollar into a million dollars in just 21 short days? That is the best illustration of compounding interest we have ever seen.

Einstein called compound interest the eighth wonder of the world and claimed that it had more power than the atom itself. This illustration assumes that you are able to invest the dollar and keep the investment gains. However, in our investment world, it is rarely the case that we can invest without being taxed on the gains we receive.

Let's look at this illustration and assume that we will be required to pay tax at a 21% tax rate--close to that of an average American according to the non-partisan tax foundation . If you were to pay tax at a 21% tax rate, in 21 days, instead of ending up with one million dollars, you will have slightly over one hundred fifty thousand dollars. That is over a eight hundred and fifty thousand dollar difference—all because of taxes!

In this special report we're going to show you:

- How you can generate up to five hundred thousand dollars in profit and pay zero federal income taxes;
- How to use 1031 tax-deferred exchanges to defer taxable gains;
- How capital gains taxation can allow you to cut your tax bill in half;
- How using corporations and other business entities can help you to manage your tax obligations and so that you become richer faster;

- How to accelerate your depreciation deductions so that you have more income and less tax; and
- Techniques to sell highly appreciated property without losing the bulk of the gain to tax.

Make $500,000 and pay zero Federal Income Taxes

If you sell your own home, and you have lived there for at least two of the past five years as your principal residence, then you can sell the house, and take out a tax free a gain of $250,000 if you are a single person, or -- get this -- $500,000 tax free if you are a married person! Isn't that incredible!

As a married couple you buy a house, down the road you sell it and perhaps it has gone up in value $500,000, you can actually sell the house, take the entire profit of $500,000 and do anything you want with it -- and you never have to pay taxes on the profit!

In most states you do not have to pay state income tax on the gain. In all states you will be exempt from federal income taxes on the profit. Keep in mind that state income tax is just a few percent, and that you are avoiding the large percentage tax, which is the federal income tax on that sale.

You can employ this technique buying a house at a discount using our investment real estate bargain-buying strategies, live in the house for two years, then sell the house and take out the profit tax-free.

You could use that money as a down payment on your next house, to start a business, as a retirement nest egg or for any purpose you wish. After you flip three or four houses using this technique, even if you started with no money of your own, you would probably own your house free-and-clear.

Imagine how far ahead you would be if in a six to eight year period you owned your home debt free! It takes most people thirty years of payments to own their home but you would do it in six to eight years!

So you could make a strategy out of buying properties at a discount, living in them for two years then selling them and buying another property at a discount, living in it for two years then moving on. If do that a few times you will be on your way to financial freedom—perhaps you will own your house free and clear or perhaps you will have enough of a nest egg to retire. The options are endless.

Key Points to Selling Your Residence Without Having to Pay Tax:

- The exemption from taxation is for your principal residence only;
- You must have lived there in the property as your principal residence for at least two of the past five years;
  - There are some exceptions. If you are moving in less than two years, consult with your tax accountant to see if you can qualify for a partial exemption.
- For single people the exemption is $250,000;
- For married couples it is $500,000; and
- This replaces the old rules of trading up to a more expensive house and the one time over 55 years of age exemption from taxation on the sale of a primary residence.

Capital Gains v. Ordinary Income

(How to Substantially cut your taxes when you sell an investment property)

Another rule we want to tell you about is the difference between profits taxed as *capital gains* versus profits taxed as *ordinary income*. Capital gains are gains (profits) that you have from the sale of an investment property that you held for longer than one year. The government charges a much lower tax rate on income it classifies as "capital gains" versus income classified as "ordinary income." Taxes on income classified as "capital gains" would be calculated using the capital gains tax rates - typically 15% (can range from 10% to 20% depending upon the particulars of your situation). This is in contrast to the tax rate on regular income - typically 21% but as high as 39.6% if you are in the top tax bracket.

For example, if you bought a property on January 1, 2016, and you sold it January 2, 2017 for a profit of $100,000, your taxes would be calculated as a "capital gain" because you owned the property for more than a year. The expected rate of tax as a capital gain would be 15%; so, you would owe $15,000 in taxes. If you were taxed at the regular non-capital gains rates of 21% your tax would be $21,000. Example "A" below is a detailed example of how capital gains treatment saves you a lot of money. Note that if you are in a higher tax bracket your savings are even more dramatic.

Note: Repairs and improvements you put into the property would be taken into account when calculating taxes. You can estimate the taxable gain by adding the repairs and improvements to the purchase price. The purchase price plus repairs and improvements is referred to as your "taxable basis" in the property. Also note the "resale price" would be net of costs of sale such as commissions and transfer tax.

Example "A"

Comparison Capital Gains v. Ordinary Income

First lets go through the math to show how the taxable gain would be calculated – you will first calculate your "basis" (pronounced "bay-sis") in the property, they you will calculate your net resale price (resale price less certain costs) then you will calculate your net taxable gain.

1. First, calculate your "Basis" in the Property
    a. Purchase Price of Property January 1, 2016 $340,000
    b. Repairs and Improvements $ 10,000
    c. Taxable Basis $350,000
2. Second, Calculate your Net Resale Price
    a. Resale Price of Property January 2, 2017 $477,000
    b. Commissions Paid to Real estate agent ($27,000)
    c. Resale Price for Tax Purposes $450,000
3. Third, Calculate Your Net Taxable Gain (profits for tax purposes)
    a. Resale Price for Tax Purposes $450,000
    b. Taxable Basis ($350,000)
    c. Taxable Gain $100,000

Gain Taxed as Ordinary Income

(Property sold in one year or less).

- Typical tax rate 21%
- Taxable Gain $100,000
- Tax Rate 21% (yours may vary but that is the "average" rate Americans pay)
- Tax Due $ 21,000

Gain Taxed as a Capital Gain

(Property sold after one year and one day)

- Typical capital gains tax rate is 15%
- Taxable Gain $100,000
- Tax Due $ 15,000

You save $6,000 by enjoying capital gains treatment v. ordinary income treatment! If you were in the highest tax bracket of 39.6% you would have saved $24,600!

Key Learning Points to Capital Gains Tax Treatment:

- This rule is just for investment properties, not for your personal residence;
- A capital gain results a lower tax rate than your regular income tax rate;

- For most people, a capital gains tax rate is 15%, as compared to income tax rates, which are typically 21% but potentially higher;
- Armed with this knowledge, you can substantially cut your tax bill!
- You must own the property for more than one year;
- If you get to the point where you've had an investment property for nine months and you want to flip it, it is probably worth keeping it for the extra three months, to convert a gain that would be treated as ordinary income into a gain that will enjoy capital gains treatment;
- The relevant dates for calculating time you held the property are the buy and sell settlement dates, not the date that you or anyone else put the property under contract.

How Using Entities (Corporations, LLCs, LPs, Trusts, etc.) Affects Your Overall Tax Bill.

Entities can help protect you from liability and if you choose the right entities, they can even reduce your tax bill. Entities you can choose from include Corporations, Trusts, LLCs, Limited Partnerships (LPs), Family Limited Partnerships (FLPs) as well as more exotic entity structures. There are variations within the entities themselves (i.e." and "C" corporations/revocable and irrevocable trusts). Each variation has tax implications that you need to be aware of.

Note: Be sure to evaluate the tax implications of any asset protection strategy. The choice of entity for asset protection will have a distinct tax implication. You need to consult with your accountant on that.

It is a common misunderstanding that if you keep profit inside the entity, you do not owe taxes on said profit; however, that is not true. Depending on your choice of entity, the profits will either flow through to your personal tax return and to the personal tax returns of any partners you may have or the entity itself will pay tax on the income. In other words, if you buy a property in an entity then sell it for a profit, even if you let the profit sit in the entity, the income will be taxable and taxes will have to be paid even though the money is left in the entity.

Pass-Through Entities

The IRS classifies some entities as "pass through" for tax purposes. This means the income "passes through" to the owners of the entity. This is contrasted to entities that are not "pass through" in which the profit is taxed at the entity rate and then again when profits are distributed to the owners of the entity. Having the same income taxed twice is called "double taxation." Double taxation is where the entity pays taxes on the income left within the entity then, upon distribution of the income to the entity's owners, the owners pay personal income tax on the income distributed. Obviously, double taxation is something we want to avoid.

The entities subject to the possibility of double taxation are "C" Corporations, LLCs electing for taxation as "C" entities, and Irrevocable Trusts. It is not a foregone conclusion that these entities will cause double taxation; it is simply possible that if you are not careful with their use, you could cause double taxation.

"S" Corporations, Limited Partnerships, LLCs choosing to be taxed as partnerships or "S" Corporations, and Revocable Trusts are not subject to double taxation. In some instances, abuse of an "S" corporation (as defined by the IRS) could actually result in double taxation. However, this is a result of abuse and it therefore something we hopefully won't have to worry about.

The income that is generated within the entities that are not subject to double taxation is "passed through" to the owner's tax return. The income is reported on the owner's tax return who then becomes responsible for paying the appropriate tax on the income. Every corporation is first formed as a "C" corporation. An IRS form has to be filed to declare "S" corporation status. Therefore, if you desire a corporation to be a "pass through" entity, be sure to declare "S" corporation status. There are time limits and deadlines to filing for "S" status so be sure to check those out. Generally speaking the "S" Election form needs to be filed with the IRS within seventy five days of forming the entity if the "S" Election is for the first year the entity exists. If it is not within the first year then the "S" Election must be filed on or before March 15 of the year you want the election to be effective.

Let's look at the same figures we used for example "A" above and see what the potential impact of using a pass-through entity versus a non-pass through entity.

Example "B"

Comparison of Pass Through v. Non-Pass Through

1. Calculate your "Basis" in the Property

    Purchase Price of Property January 1, 2016 $340,000

    Repairs and Improvements $ 10,000

    Taxable Basis $350,000

2. Calculate your Net Resale Price

    Resale Price of Property January 2, 2017 $477,000

    Commissions Paid to Real estate agent ($ 27,000)

    Resale Price for Tax Purposes $450,000

3. Calculate Your Taxable Gain (profits for tax purposes)

Resale Price for Tax Purposes $450,000

Taxable Basis ($350,000)

Taxable Gain $100,000

For purposes of this example, if you did not use a pass-through entity ("C" Corporation or Irrevocable Trust), we will assume the tax rates applicable to a "C" corporation for illustrative purposes. The corporate tax rate is tiered. The first $50,000 of income left within a "C" corporation enjoys a very low tax rate of 15%. The next $25,000 of income is taxed at 25%. The next $25,000 of income is taxed at 34%. In this example your total tax bill would be $22,250.

Bear in mind that this tax is due from the entity. It does not represent what the owners of the corporation will have to pay from a tax perspective if the income is later distributed as dividends. This is what we have been referring to as double taxation. The entity would first pay taxes then the monies that are distributed to the owners of the entity would pay taxes a second time on that same income!

Let's retrace what happens. First taxation occurs at the company's year-end when it must pay taxes on its earnings. The second taxation occurs when the shareholders receive the dividends, which come from the company's after-tax earnings. The shareholders pay taxes first as owners of a company that brings in earnings and then again as individuals, who must pay income taxes on their own personal dividend earnings. There are ways to manage earnings within a non-pass through entity v. distributing dividends. However, for this example, we are illustrating the traditional taxation of the "C" corporation without the benefit of proper tax planning.

Taxes Due from Entity

Taxable Gain $100,000

Entity Tax Rate 15% on the first $50,000, 25% on the next $25,000, 34% on the next 25,000

Tax Due from Entity $22,250

Taxes Due from the Owner of the Entity

Distribution from the Entity $85,000

Dividend tax rate (generally capital gains rate) 15%

Tax Due from Owner $12,750

Total Taxes

Tax Due from Entity $15,000

Tax Due from Owner $27,200

Total Taxes $35,000

Note: Above we showed how capital gain treatment dramatically cuts your tax burden as compared to ordinary income treatment. Capital gains treatment as compared to using a non-pass through entity is also allows you to come out ahead—by $20,000!

Not all "pass throughs" are created equal

If you choose to use a "pass through" entity to title your properties, you must be aware that not all "pass through" entities are created equal. In other words, an LLC, Limited Partnership (LP), and Revocable trust are taxed differently than an "S" corporation. Let's look at how an LLC electing to be taxed as a partnership or "S" corporation and/or Limited Partnership are treated from a tax perspective.

LLC taxed as an "S" Corporation or Partnership

Taxable Gain $100,000

Entity Tax Rate 0%

Tax Due from Entity $0

Taxes Due from the Owner of the Entity

Distribution from the Entity $100,000

Owner's Tax Rate 15% (capital gain—assuming property was held for at least one year and one day)

Tax Due from Owner $ 15,000

Total Taxes Using Pass-Through Entity

Tax Due from Entity $ 0

Tax Due from Owner $15,000

Total Taxes $15,000

It is critical to know that LLC and/or LP income maintains its character. That means that if the LLC income is capital gain income, the income maintains its character (as capital gain income) as it flows through to its owners. Therefore, if the income is ordinary income (as illustrated above when a property is sold prior to owning it for at least one year and one day) the flow through income to the owners of the LLC will be treated as ordinary income. This is an important key when deciding which entity to use in your overall strategy. Before we explain what we mean, let's look at the taxable results when we use a "pass through" LLC that sells a property it has not owned for at least one year and one day and will therefore generate ordinary income.

LLC

Taxable Gain $100,000

Entity Tax Rate $0

Tax Due from Entity $ 0

Taxes Due from the Owner of the Entity

Distribution from the Entity $100,000

Owner's Tax Rate 21% (ordinary tax rate)

Tax Due from Owner $ 21,000

Total Taxes Using Pass-Through Entity

Tax Due from Entity $ 0

Tax Due from Owner $21,000

Total Taxes $21,000

You may be surprised to see that using a "pass through" entity did not help you much as compared to the "non-pass through" when it comes to ordinary income. So, the key point here is that no matter which way you slice it, when income is treated as ordinary income, whether or not you have an entity, it will cause you to have a much higher tax bill than if your income is classified as capital gain.

"S" Corporation

Taxable Gain $100,000

Entity Tax Rate $0

Tax Due from Entity $ 0

Taxes Due from the Owner of the Entity

Distribution from the Entity $100,000

Owner's Tax Rate 21% (ordinary tax rate)

Tax Due from Owner $ 21,000

Total Taxes Using Pass-Through Entity

Tax Due from Entity $ 0

Tax Due from Owner $21,000

Total Taxes $21,000

Unfortunately, there is no capital gain treatment and/or advantage when using a corporation—"S" or "C".

By now you may be coming to the conclusion that using an entity might be more trouble than it is worth. However, you have to remember that first and foremost, an entity will protect you personally from potential legal liability from your real estate activity. Additionally, now that you are aware of what these entities do from a tax perspective, you can use them to tremendous advantage.

The foregone conclusion is that ordinary income is bad (at least from a tax perspective); however, the market may dictate that you sell a property sooner that one year and one day. Additionally, if you are intent on capitalizing on the market, you may want to do the same thing with multiple properties. In other words, it may be imperative that you flip properties to generate a profit. Not only will you receive ordinary income, it is quite possible that you will be deemed a dealer and therefore, incur employment taxes and lose the benefit of depreciation and long term capital gains tax rates for rental properties. An "S" corporation can help you manage the employment taxes. An "S" corporation provides the capability of taking some income that will be subject to garbage (employment) tax while taking additional income that is treated as a draw that does not incur employment tax. Therefore, an "S" corporation is, at times, a critical tool to avoiding the devastating tax ramifications of being a dealer and losing depreciation and long term capital gains tax treatment.

Example "C"

Total Taxes Using "S" Corporation

Tax Due from Entity $0

Distribution from the Entity $60,000 as salary

Distribution from the Entity $40,000 as a draw

Owner's Tax Rate 21% (ordinary tax rate)

Employment tax rate of 15.3%

Total Tax Due $30,180

Taxes Due from Sole Proprietor/Dealer

Taxable Gain $100,000

No entity

Owner's Tax Rate 21% (ordinary tax rate)

self-employment tax rate of 15.3% of 92.35% of the self-employment income

Tax Due from Owner $ 36,300

These illustrations do not include legitimate tax deductions that, as a business owner and real estate investor, you will be able to take. These generally include expenses you incur operating your business (phone lines, phone usage, car mileage, continuing education, postage, tools, etc.).

The use of the proper entity structure will allow you to maximize the deductions you are able to take. For instance, a "C" corporation will generally allow you to maximize the deductions for certain medical benefits (medical premiums and un-reimbursed medical expenses like deductibles, vision care, dental care, chiropractic care, acupuncture, vitamins, etc…). Therefore, in addition to choosing the proper entity, it is also vital that you allow your entity to pay for every legitimate expense it can pay for. In doing so, you will pay for these items "above the line" (before tax). As you can see from the illustrations above, paying for things prior to taxation will provide somewhere from 15%-46%+ more money for you.

As you can see, your total tax bill is a product of the type of income you generate and the entity in which the income is generated. However, if you want a guideline, keep in mind that generally, an LLC or Limited Partnership is the entity of choice for real investors as opposed to a corporation. There are many reasons for not using a corporation. To follow are the main reasons: because there is no capital gains treatment within a corporation,

- rental losses are not deductible by shareholders of a "C" corp.,
- refinancing a property owned by a Corporation and cashing out will create a taxable event,
- There is no debt-basis for shareholders of an "S" corp. when obtaining a third-party loan,
- No step-up in basis for your beneficiaries

Generally you will favor a corporation to an LLC or LP if there is potential for you to be considered a dealer. The corporate structure, particularly an "S" corp., will enable you to manage the self-employment tax associated with dealer income. A "C" corp. can be used to maximize self-funded benefits and fringe benefits. Therefore, it is typical in practice to utilize multiple entities in a tax strategy to maximize the tax strengths of various entities.

Note: If you have a corporation and you do not want it to be subject to double taxation, you need to elect to have the corporation treated as an "S" corporation. This is accomplished by filing a form with the IRS. The election form must be filed on or before March 15th of the year in which you want the corporation treated as an "S" corporation, or within 75 days of forming the entity.

You need to consult with your CPA to determine which structures to use. It is a sophisticated analysis that needs to take into account the particulars of your situation. What you need to know is that you should never hold rental properties in a corporation and that you will favor an "S" corporation to manage self-employment tax and a "C" corporation to maximize personal, fringe benefits.

1031 Tax-Deferred Exchanges

1031 Tax Deferred Exchanges are one of the most exciting tax reduction opportunities for real estate investors. A 1031 Tax Deferred Exchange allows you to trade one investment property for another without having to pay the taxes on the money you made on the first property until you sell the second property. If you die before selling the second property you may even be able to avoid ever paying. The exchange is, in most cases, similar to a traditional sale and purchase; therefore, even though the 1031 exchange sounds ominous (to some), it really is not.

Example "D" – Apartment Building

Bob bought an apartment building for $650,000. When it is finished, it is going to be worth $2.4 million. Bob will ultimately have the choice of selling the property, pay the taxes then go on to his next property. Or Bob can use the 1031 exchange to defer the tax until sometime in the future when he sells the building he exchanged for without exchanging into a new (third) building.

Therefore, in the example of an apartment building deal Bob is working on in the University City section of Philadelphia, he would have $1,200,000 if he uses the tax-deferred exchange versus only $870,000 if he does not use the tax-deferred exchange. That's a $330,000 improvement.

Essentially, a tax-deferred exchange can allow you to roll a property over into a better performing property. You can accomplish this on a tax-free basis. You can use leverage and "trade up" into a more valuable property. You can also "trade down" into a less expensive property. You will be taxed on the difference between the property you are relinquishing and the property you are obtaining (this is called "boot"). You are not limited to just one property to be relinquished and one property to be acquired; you may have multiple property transactions in one exchange. Therefore, you can diversify a portfolio of investment property without a tax consequence.

As you have seen, tax rates on gains can have a huge impact on your ability to create wealth. We have explored the ordinary income tax rates and capital gains tax rates. In addition to those taxes, selling a property will also demand that you recapture depreciation, you may have to pay an alternative minimum tax (AMT) if certain amounts of income are met, you may incur a state income tax liability, and the sale may increase your personal income tax bracket. Upon an increase in your adjusted gross income, your social security tax is increased, you can potentially reduce or eliminate your ability to claim certain itemized deductions like casualty/theft losses, IRA deductions, personal exemptions, the $25,000 passive loss allowance for rental properties and the child care credit. So, as you can see, it is important that you plan prior to liquidating a property.

Let's look at details of Bob's apartment building transaction so you can understand the mathematics of simply selling the property and paying the taxes versus using the tax-deferred exchange.

Comparison of 1031 Exchange versus Selling a Property outright

Example "E"

Example of Transaction NOT using the Tax-Deferred Exchange:

1. Calculate "Basis" in the Property

    Purchase Price[5] of Property March 1, 2016 $ 650,000

    Repairs and Improvements $ 350,000

    Estimated Tax Basis $1,000,000

2. Calculate Net Resale Price

    Resale Price[6] of Property September 1, 2017 $2,400,000

    Commissions Paid to Real estate agent,

    Transfer Taxes and other expenses of sale ($ 200,000)

    Resale Price for Tax Purposes $2,200,000

3. Calculate Taxable Gain (profits for tax purposes)

    Resale Price for Tax Purposes $2,200,000

    Taxable Basis ($1,000,000)

    Taxable Gain $1,200,000

4. Calculate Taxes on the Profits

    Taxable Gain $2,200,000

    Tax Rate (long term capital gain @20% rate)

    Taxes $440,000

    (this does not account for recapture of depreciation)

5. **Calculate Cash Remaining After Taxes**

    Cash from Closing $2,200,000

Taxes Paid ($440,000)

Repayment of Loans used to purchase and renovate ($1,000,000)

Remaining Cash $760,000

Therefore, if Bob sells the building and pays the taxes, he will have only $760,000 left to work with.

Example "F"

Example of Transaction Using the Tax-Deferred Exchange:

1. Calculate "Basis" in the Property

   Purchase Price of Property March 1, 2016 $ 650,000

   Repairs and Improvements $ 350,000

   Estimated Tax Basis $1,000,000

2. Calculate Net Resale Price

   Resale Price of Property September 1, 2017 $2,400,000

   Commissions Paid to Real estate agent, Transfer

   Taxes and other expenses of sale ($ 200,000)

   Resale Price for Tax Purposes $2,200,000

3. Calculate Cash Remaining After Taxes

   Cash from Closing $2,200,000

   Taxes Paid the taxes are deferred into the future) ($ 0)

   Repayment of Loans used to purchase and renovate ($1,000,000)

   Remaining Cash $1,200,000

Therefore, if Bob sells the building and exchanges into another building, he will have $1,200,000 to put into the next project!

What does keeping the difference between $760,000 and $1,200,000 mean when it comes to wealth accumulation? Let's assume Bob will receive a 10% rate of return in the new building and he keeps that building for another 10 years, the $440,000 saved by using the 1031 exchange will grow to be $1,037,496. That cash was created by money that would have otherwise been surrendered to tax.

The rule allowing the 1031 Tax-Deferred Exchange is found in the Internal Revenue Code in section 1031. In summary the rule states that the IRS does not "recognize" --meaning it does not count for tax purposes -- a gain, that you have on a property if you exchange it for a different property. There are some terms that you need to know that are associated with this rule, and one of those terms is "basis." "Basis" is what the Government pretends that you paid for the property. This may be a little different from what you actually paid. A simple way to understand how to calculate basis is to take what you paid for the property and add any repairs you put into the property. That is your "basis." The "basis" will sometimes be referred to as your "adjusted tax basis." Another term is you need to be familiar with is "taxable gain." "Taxable gain" is the sale price of the property less the cost of sale less your "basis" in the property. Your actual tax bill is calculated by multiplying your "taxable gain" by the tax rate. Keep in mind that you will have to deduct any depreciation that you have taken from your basis. Depreciation is discussed below.

1031 Rules

There are many technical rules surrounding 1031 exchanges. For instance, you are not allowed to touch the money; instead, the money is held by a neutral third party. If you are doing a tax-deferred exchange, you have to have professional help so that you are able to follow the rules and to help you find a "qualified intermediary" to hold the money and facilitate the exchange properly. As stated above, there are special rules you will be guided through as you perform the exchange. These rules include but are not limited to:

- You must use a qualified intermediary (QI);
- You must use a qualified escrow account for a delayed exchange;
- You must identify a replacement property within 45 days;
- You must close on the replacement property within 180 days;
- You must follow the rules surrounding transactions with related parties (i.e. your brother, father, mother, and other relatives);
- Both the relinquished property and the replacement property have to be held for business use; and
- Neither property can be your personal residence.

The professionals can help work situations to your advantage. First you will probably need to do a "step transaction" which means you are not going to trade your property with another owner with a different property who also wants to do a 1031 tax-deferred exchange.

For example, it would be very unlikely that Bob would find someone to trade the $650,000 apartment building mentioned above for another fixer-upper building in his investment area. Typically, exchanges are "step transactions" that involve three parties. You sell your property to one person and buy a property belonging to an unrelated person. Using the "step transaction," even though you did not trade properties with one person, still counts as a tax deferred exchange.

The person who orchestrates the exchange is called an "intermediary." When you sell your property, the intermediary holds the money. When you buy the new property, the intermediary actually goes out and acquires it for you, puts it under contract, takes the money from the sale of your first property, and puts it toward the purchase of the second property. The property is then titled to your name.

The good news is that the intermediary arranges everything so you don't have to understand all the complicated, technical rules nor do you have to do the complicated tax work! Remember that if you touch the money, you cannot do a tax-deferred exchange. An intermediary has to handle the money. This means you need to decide that you want to do a 1031 Exchange before you close on the sale of your first property and before you buy the second property.

As a word of caution, do not use the buyer as an intermediary. In the past it was common to allow the buyer of the relinquished property to act as the intermediary in what was known as an "ABC Exchange." These kinds of exchanges are not permitted by the IRS safe harbor regulations. Essentially, if you want the IRS to bless the exchange, you must use an outside, QI on all exchanges. When you are buying or selling with a plan of doing a 1031 exchange, you will use a special contract. The contracts used to buy and sell the properties will often use the word "exchange" instead of "sale" and refer to IRS rule 1031 throughout the document. The intermediary should help you with the contract as part if his work.

Like Kind Rule

The properties have to be something called "like kind." Many incorrectly believe "like kind" is narrow. 1031 rollovers apply to a diversity of small, large, residential, etc…investment properties. In fact, raw land can be rolled over to an income producing property and vice versa. "Like kind" means "investment real estate for investment real estate." It doesn't mean that you have to exchange a high-rise rental condo for another high-rise rental condo. You can trade the condo for a warehouse you rent to a business, for an apartment building, or for any other sort of investment real estate, even a farm or a parking lot! You can exchange almost any kind of investment real estate for another kind of investment real estate. The key is that both the property that you are giving up, and the property that you are acquiring have to be held for business purposes, or business investment. Remember, neither property you buy nor the property you sell can be your personal residence.

Key Items to Remember – 1031 Exchanges

There are strict technical requirements for you to do a 1031 tax-deferred exchange. Here are some of them:

- The properties have to be "like kind," which means investment real estate for investment real estate;
- A third party intermediary has to handle the money;
- You cannot do a like-kind exchange with property that is in the United States and exchange it for property outside the United States;
- You cannot exchange properties that are outside the United States for property inside the United States;
- You can exchange one foreign property for another;
- You cannot touch the money, so you are going to use a third party called a "qualified intermediary" (often an attorney or Title Company) to help you out with the transaction and to hold the money;
- The intermediary cannot be related to you, and you can't control them. If you do, the IRS will disallow the exchange, and charge you the taxes;
- You will probably do a "three party exchange" which means that you don't have to find someone to trade properties with; you can sell one property to a buyer, and then exchange for a different property in separate transactions;
- It is okay to do multi-party exchanges, but they get very complicated. You might trade two or three properties before you finally get the property you want. The way that happens is that your intermediator, sometimes called your accommodator, will go out and buy your replacement property. The accommodator will sell your existing property, and at the end give you the replacement property;

- The paperwork needs to be done correctly, so it is important you use a professional company that does tax-deferred exchanges frequently; and
- There is a time limit to completing the steps to the exchange.

Time Limits in 1031 Exchanges

The identification period is your time limit to identify the property that you are going to exchange into (buy). You must identify the property within 45 days of selling the first property. (Remember you CANNOT touch the money and must start the 1031 Exchange prior to selling your property).

When you are speaking with people about 1031 tax-deferred exchanges you need to know the lingo. "Relinquished property" is the property that you are selling. "Replacement property" is the property you are buying.

You can identify up to three different properties, or you can identify an unlimited number of properties, as long as they don't exceed 200% of the fair market value of the property that you are giving up.

You have to be careful not to identify too many properties because you have to close on the property you are buying within 180 days. Additionally, there is a tricky rule that you have to keep in mind. If your taxes become due during the exchange period (the 180 days from the time that you identify the property to the time you close on it) and April 15th falls during that time, you have to file an extension. You cannot file your taxes. This means that if you are doing this between October 25th, and the end of the year, then you have to be careful, because once you get past October 25th, the 180-day period is going to be shortened, because it ends on April 15th, unless you file an extension.

There will be special agreements that your qualified exchanger or qualified intermediary will give you:

- A "Deferred Exchange Agreement";
- An "Assignment Agreement," where the intermediary becomes the seller of the property you are selling; and
- Closing instructions, which direct the intermediary to sell the property for you, buy the next property for you, then deed the new property to you.

The details are complicated. The good news is that the intermediary handles the complicated tax parts for you and using 1031 exchanges can save you hundreds of thousands of dollars in taxes. A 1031 exchange is a powerful technique for building up your wealth. Instead of having to pay taxes on your profits, you instead keep that money out there working for you, working on your behalf!

Note: there is a technique that may allow you to avoid the 45/180-day deadlines. It is called a reverse or "Starker" exchange. Although it can be difficult to execute, it can relieve the pressure asserted upon you by the deadlines so that you don't get yourself into a less than desirable deal while still saving the tax.

The Magic of Depreciation

Depreciation can allow you to make money on rents every year yet not pay taxes on that income! Depreciation is an accounting concept based on the premise that tangible items such as equipment and buildings become less valuable over time and need to be replaced. Depreciation is an attempt to match the decline in value and usability of a tangible item to its useful life.

It is an allowable tax write-off of the cost basis of certain assets held for rental or business use. Depreciation also happens to be the real estate investor's most powerful tool. The determination of depreciation is based on the entire cost of the property regardless of financing. The amount of depreciation is generally unaffected if you paid cash for the property or financed it entirely. Depreciation, coupled with interest deductions, can create high yields and substantial tax losses.

What is interesting when depreciating real estate, you are allowed to take a deduction without expending cash while the property is actually appreciating. The depreciation deduction can reduce ordinary income rates.

The way depreciation is calculated is to take the cost of the item, divide it by its expected useful life, and that figure becomes an annual depreciation charge. At the end of a tangible items useful life its value on the books is zero. The accounting idea is that the value of the item on the internal books of the owner would more accurately reflect the items true market value and usability. It would also make it easier to decipher when items will need replacing and thus projections of expenses will be more accurate. Real estate is unusual in the realm of tangible goods because, as mentioned above, it tends to increase in value every year rather than decrease in value. We don't expect our car, computer, or television to increase in value but we do expect our real estate to appreciate.

In terms of rental properties, the tax laws allow you to calculate your annual depreciation and deduct it from the income generated by the property. This can result in significant tax savings. Generally, the formula to calculate annual depreciation is the taxable basis in a building, divided it by 27½ (the typical depreciation timeline).

Example "G" – Annual Depreciation Calculation

Let's say you paid $275,000 for a residential rental property, your annual depreciation expense would be $10,000.

Taxable Basis (your cost to acquire the property plus improvements)

$275,000

Annual Depreciation (your taxable basis divided by 27.5)

$275,000/27.5 **= $10,000**

Remember depreciation is not an actual, tangible expense. You don't write anyone a check for depreciation. Each year you are allowed a deduction from income generated by the building equal to 1/27.5 of your basis. This non-cash deduction offsets other income from the property.

Example "H" – Effect of Annual Depreciation

As we saw in the example above, if you paid $275,000 for a rental property, your annual depreciation expense would be $10,000. If the property generated $12,500 in income, depreciation would cause your taxable income from that property to $2,500. Income from the property (rents) $12,500

Annual Depreciation ($10,000)

Taxable income $ 2,500

Assuming you are in a 32% tax bracket, your taxes from income on the property would be $800 ($2,500 income X 32% tax rate) rather than $4,000 ($12,500 income X 32% tax rate). You would save $1,500 in tax every year.

Depreciation is only for business and investment property. It is not applicable to your home or other tangible property held for personal use. There are times when/if you have a home office, you could enjoy depreciation on that part of your home; however, keep in mind that you will have to recapture the depreciation associated with the home office at the time your home is sold. It is also not applicable to property held for resale. In plain English, "property held for resale" means property you buy intending to flip for a profit rather then holding as an income producing property (rental).

The Downside to Depreciation

The benefits to depreciation far outweigh the drawbacks; however, it is important that you are aware of the potential drawbacks. Passive loss limitations are, essentially, limitations on depreciation deductions. These passive loss limitations attempt to limit currently deducting rental losses against other types of income (i.e. business income, W-2 income, interest income, dividend income,…). Passive losses can be carried forward and proper planning can allow you to maximize your ability to take your passive losses.

When property is sold, the depreciation that has been taken for the property reduces the basis of the property. This increases your gain. This has been used as an argument for not taking a depreciation deduction, however, time value of money suggests that taking the depreciation deduction will produce more for you in the long run versus not taking the deduction. In other words, the deduction allows you immediate use of the funds that can be invested to produce income/wealth for you rather than deferring use of the same funds.

The recapture of depreciation that is part of the realized gain when a property is sold is taxed as ordinary income. Again, the time value of money suggests that taking the depreciation deduction, in the long run, creates better results for you.

AMT (Alternative Minimum Tax) is an IRS strategy to reduce the benefit of certain tax preferences. Certain depreciation deductions fall into the category of preferences that may cause AMT. Generally, these are not significant plus there are AMT exemptions and planning techniques to mitigate the effects of AMT.

Accelerating Depreciation to Increase Depreciation Deductions

If you notice above, we used the term "typical depreciation timeline." Most tax preparers use the 27.5-year depreciation schedule; however, there are items or components within any given property that may qualify for a different, shorter depreciation timeline. By breaking out the cost of the property into its various components, you are allowed to depreciate the components according to their specific timeline. Therefore, if a component is on a 5-year recovery period, you will be able to depreciate the component over 5 years instead of 27.5 years. Therefore, let's imagine that we have a component that is on a 5-year recovery period and its cost was $1,000. If you were using the typical 27.5-year depreciation timeline, your deduction would be $36.36. However, if you use the component's 5-year depreciation schedule, the deduction increases to $200.00. That is an impressive difference. Bigger deductions mean more money in your pocket.

Benefits of Being a Real Estate Professional

A way that you can maximize your passive loss deductions is to qualify as a Real Estate Professional. It is one of the biggest tax loopholes available to real estate investors today; therefore, as you can imagine, the IRS doesn't like it. In fact, as we write this, we are aware that the IRS is challenging many taxpayers claiming they are Real Estate Professionals. The IRS is particularly targeting realtors. Simply having a license to sell real estate will not qualify you as a Real Estate Professional. We do not want to dissuade you from qualifying, we simply want you to be prepared to defend the qualification.

Time requirement

If you spend at least 750 hours per year, or more than half of your working hours, involved in real estate activities, you generally qualify as a "real estate professional."

If you are a "real estate professional" who "materially participates" in managing your investment property, you are allowed almost unlimited income tax-deductions from your investment property. If you invest in real estate but do not qualify as a "real estate professional", you are limited to a maximum annual $25,000 realty investment property loss deduction against your ordinary taxable income. This is the passive loss limitation that we discussed earlier. This "loss" includes the paper loss created by depreciation. However, there is another catch. If your annual adjusted income exceeds $100,000, the $25,000 loss deduction gradually phases out. At the $150,000 adjusted income level, the allowable tax loss deduction goes to zero. Any un-deducted real estate investment tax loss is "suspended" for future use, such as at the time the property is sold at a profit. Then you may subtract the unused suspended tax loss from your capital gain to lower the taxable profit.

Material participation requirement

Participation is key. You may be able to still meet the material participation requirement and claim the unlimited tax deductions as a professional even if you hire a professional property manager. Day-to-day operating details, such as collecting rents, evicting tenants and unclogging toilets, can be delegated to this manager.

But, you must make the major decisions, such as setting rents, approving major expenses and qualifying new tenants.

Compliance

Be sure to document thoroughly. You may find yourself having to defend your qualification as a professional. Documentation will save your bacon.

They say death and taxes are inevitable. What they don't tell you is that death can sometimes defeat taxes. When you die, your heirs will become the owners of the real estate that you owned before your death. They inherit the real estate with what is called a "stepped-up basis," meaning that the IRS will readjust the taxable basis of the property to market value as of the day of your death. This can save your heirs hundreds of thousands of dollars.

If you sold a fully depreciated property (meaning you took depreciation for 27.5 years or accelerated the depreciation) your entire sale price (net of selling expenses like real estate commissions) would be would be taxable as income. This is different than selling the same property before you took depreciation because the "profit" for tax purposes is the net sale price less the basis in the property. If your basis is less than your net sale price (because you depreciated the property or because it sells for more than you paid for it) then you owe taxes on the difference between the net sale price and your basis. If the property had been the $275,000 property I used in example "G" above and you sold it for $550,000 prior to your death, your tax bill would look like this:

Example "I" – Sale of Fully Depreciated Property

We'll use the 27.5-year depreciation example for illustrative purposes

1. First, Calculate your total depreciation taken

   Annual Depreciation Charge $10,000

Number of Years Depreciation Taken X 27.5

Total Depreciation Taken $275,000

2. Second Calculate Your Remaining Basis in the Property

   Original Taxable Basis in the Property $275,000

   Less Depreciation Taken ($275,000)

   Remaining Basis $0

3. Third, Calculate Your Taxable Gain on Sale of the Property

   Net Sale Price (sale price less costs of sale) $550,000

   Less: Remaining Basis $ 0

   Taxable Gain $550,000

4. Fourth, Calculate Your Taxes (we'll assume a 32% tax rate)

   Taxable Gain $550,000

   Tax Rate X 32%

   Taxes Due $176,000

Example "J" – Sale of Fully Depreciated Property by Your Heirs After Your Death

If the property had been disposed of after your death, the $275,000 property used in example "H" would have zero tax ramification to your heirs. The calculation would look like this:

1. First the Basis is reset to market value as of the date of your death.
2. Your heirs get the figure from an appraisal or real estate broker
3. The figure is set regardless of how much you had taken in depreciation.
4. Assuming the property is worth $550,000, the taxable basis would be $550,000.
5. Your Heirs Calculate the Taxable Gain on Sale of the Property

   Net Sale Price (sale price less costs of sale) $550,000

   Less: Remaining Basis $550,000

   Taxable Gain $0

   Calculate Your Taxes (we'll assume a 32% tax rate)

   Taxable Gain $ 0

   Tax Rate X 32%

   Taxes Due $0

Instead of a tax bill of $176,000 your heirs will have no tax bill!

It is an unfortunate fact of life that all of us die. At least you can use the tax laws to pass on real estate without causing your heirs to lose the money to taxes arising from profits in the real estate. This is a powerful technique for transferring wealth between generations.

In any estate plan, it is important to assess the impact your real estate investments will have on your heirs. Generally, the best estate plan, beyond the structuring you will do to protect your assets from law suits and excess taxations while you are alive, will be to provide adequate liquidity to your heirs upon your death. This is most typically achieved through life insurance. Many of us don't get the appropriate amount of life insurance—at least not appropriate to meet our estate planning needs. Please know, if you are concerned with leaving a solution for your heirs versus a problem, there are ways to structure your estate and provide adequate liquidity (via life insurance) at an acceptable cost. Why do we say that you could leave your heirs with a problem? Without adequate liquidity, if you have an estate tax, your heirs have only 9 months to satisfy the IRS. We do not want to force your heirs to liquidate what you have worked so hard to create in a "fire sale."

Conclusion

We hope you enjoyed the information about reducing taxes. We hope this is the beginning of our relationship. Please register at http://www.diamondlawcenter.com for our free investing newsletter. That will get you on our mailing list where you will learn about live and telephone seminars where we can interact and I can give you more of our knowledge.

We also post information about our upcoming live events on the website or you can call us at (800) 981-2846 for more information.

For now, good luck and good investing.

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