The Renaissance Goldmine

of Brilliant Tax Strategies
for Real Estate Investors

Brand new...easy-to-use software program
that will dramatically increase your cash flow
with the absolute best
tax-saving secrets in the country!

ALBERT AIELLO, CPA, MS TAXATION, RE INVESTOR
NUMBER 1 SPEAKER ON TAX STRATEGIES FOR
REAL ESTATE INVESTORS
The Renaissance Goldmine
Transforming Real Estate Into A Formidable Tax-Reduction Machine

In this chapter we cover....

A. THE GOLDMINE EMPOWERS YOU TO TOALLTY SHELTER ALL OF YOUR REAL ESTATE WEALTH

B. THE GOLDMINE GOES EVEN FURTHER BY CREATING DEDUCTIBLE PAPER LOSSES = TAX SAVINGS = CASH FLOW

C. EXAMPLE – POSTIVE CASH FLOW OF $21,380 YET WITH PAPER TAX LOSSES OF $17,000

D. SAVING TAXES VIA THE GOLDMINE MAKES YOU WEALTHY

E. THE DILEMMA -- LACK OF RE TAX LAW KNOWLEDGE

F. THE SOLUTION -- THE RENAISSANCE GOLDMINE
A. THE GOLDMINE EMPOWERS YOU TO TOALLTY
SHELTER ALL OF YOUR REAL ESTATE WEALTH

With an investment property there are many 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

8. Tax Savings. And with the Goldmine, huge tax savings!

With the Powerful Goldmine Tax Reduction Strategies you can totally shelter all of the above wealth from the drain of taxation.

B. THE GOLDMINE GOES EVEN FURTHER BY CREATING
DEDUCTIBLE PAPER LOSSES = TAX SAVINGS = CASH FLOW

One of the unique, magical virtues of real estate investments is that a property can have positive cash flow yet still have deductible tax losses, creating tax savings. The principal source of these losses is from huge depreciation deductions via the powerful Goldmine componentizing system. (The componentizing system is discussed in later chapters). Because the acquisition and rehabbing of real estate can be done via leveraging the Goldmine componentizing deductions could be claimed without cash outlay, thus making them paper deductions that still create cash flow via tax savings. In other words, these componentizing deductions create 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). Thus, the Goldmine 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 an 8th potential source of wealth...tax savings

**C. EXAMPLE – POSTIVE CASH FLOW OF $21,380 YET WITH PAPER TAX LOSSES OF $17,000**

*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.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Property Income</td>
<td>$110,000</td>
</tr>
<tr>
<td>Less: Operating expenses &amp; vacancies</td>
<td>- 49,000</td>
</tr>
<tr>
<td>Net Operating Income (NOI)</td>
<td>= 61,000</td>
</tr>
<tr>
<td>Less: Annual mortgage payment</td>
<td>- 39,620</td>
</tr>
<tr>
<td>Positive Cash flow before taxes</td>
<td>$21,380</td>
</tr>
</tbody>
</table>

The above property is generating an annual positive cash flow of $21,380, which divided by the $50,000 down payment equates to nice **43% cash-on-cash return.** Not only is this entire huge 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 Goldmine Componentizing system, the annual componentizing deductions will be $42,000. Below is a tax analysis.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Operating Income (NOI), per the above...</td>
<td>61,000</td>
</tr>
</tbody>
</table>
2. Less: G.M. Componentizing deductions.........   - 42,000
3. Less: Interest deduction.................................   - 36,000
4. = Paper Tax Loss..........................................   $ (17,000)

In a 31% tax bracket, the $17,000 tax loss = $5,200+ of immediate tax savings, which means a $5,200+ increase to the above cash flow! (Moreover, the property will appreciate in value.)

**D. SAVING TAXES VIA THE GOLDMINE MAKES YOU WEALTHY**

Any taxes you save equal additional income to you every year. For example, even a modest $4,000 in tax savings invested every year in a self-directed Roth IRA at 10% would accumulate, tax-free, to over $63,000 in 10 years and $229,000 in 20 years. In other words without the tax savings you would not have this tax-free accumulated wealth! This is how you get wealthy, using the Goldmine!

**E. THE DILEMMA -- LACK OF RE TAX LAW KNOWLEDGE**

Most real estate entrepreneurs lack the knowledge and creativity to substantially reduce their taxes by fully taking advantage of the real estate tax shelter. Moreover, 90%+ of CPA’s, accountants, attorneys and tax advisors are very deficient in the powerful topic of real estate taxation. Consequently, most real estate entrepreneurs unnecessarily say “good-bye” to hundreds, even thousands of tax dollars every year. Lost dollars that could have been used to buy more income-producing properties!

**F. THE SOLUTION -- THE RENAISSANCE GOLDMINE**

To put a stop to this tax drain, I continue to do exhaustive and never-ending research. Consequently, I have discovered and developed hundreds of little-
known tax reduction strategies targeted toward real estate. (Remember, I am also a real estate investor.) The Renaissance Goldmine extensively reveals these hundreds of creative (but little-known) strategies available for the three main phases of real estate investment: (1) Acquisition, (2) Operation, (3) Disposition. The Renaissance Goldmine strategies not only will save you thousands of dollars in taxes, but with little or no IRS audit-risk because of audit-proofing techniques covered in the Renaissance Goldmine.

The Renaissance Goldmine is not just another tax “book”. It is a software System that contains specially designed forms (on computer disk) that show you how to implement & audit proof your tax reduction strategies. The Renaissance Goldmine, along with these forms, automatically includes the tax law citations. Now, you can be sure that you are perfectly legal and fully documented when you take advantage of these hundreds of little-known tax-saving gems. You save many hours of research time and hundreds of dollars in fees.

The Renaissance Goldmine creates a new & exciting approach to tax planning. It takes basic (even boring) tax laws and transforms them into dynamic & powerful tax reduction gems, targeted toward real estate. The Renaissance Goldmine also unearths many unknown but fantastic legal loopholes that will slash thousands off your annual tax bill. At every turn of the tax planning process, the Renaissance Goldmine implements tax reduction opportunities, enables you to avoid costly tax traps, and reduces or eliminates IRS audit-risk. Some of the strategies discussed may not only be new to you, but also surprising, even shocking and unbelievable. But, they are time-tested techniques that are based on continuous extensive research supported by tax law citations and long-standing precedent.

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW
Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours
invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Audit Proofing Your Taxes From IRS

In this chapter we will cover...

A. DO NOT FEAR THE IRS!

B. MINIMIZE OR ELIMINATE IRS PROBLEMS WITH “THE TWO-WALL DEFENSE”. THIS ELIMINATES IRS FEAR!

C. FIRST WALL IS AUDIT PREVENTION - USING STRATEGIES TO PREVENT OR REDUCE YOUR CHANCES OF AN AUDIT

D. SECOND WALL IS AUTOMATIC PRE-AUDIT PREPARATION

E. USING THE GOLDMINE TWO-WALL DEFENSE HAS IMPORTANT ADVANTAGES

F. KNOW YOUR RIGHTS AND HOW THE IRS WORKS

A. DO NOT FEAR THE IRS!

1. Don’t let the IRS weapon of FEAR cause you to overpay taxes. You are planning and preparing your return. After careful consideration, in one or two parts of the return, you decide to take a legally aggressive position......when all of a sudden you hear on the news, that "So & So" is going to jail for tax evasion. The FEAR of GOD comes over you and takes the wind out of your sails. Consequently you change your mind about your legally aggressive position and you take the more costly conservative position.
Undoubtedly the IRS' biggest weapon is *FEAR*. However this does not mean that you have to fall for these IRS fear-ploys when news of some jail sentence just so happens to occur around March or April.

2. **Gray areas and being aggressive does not get you in trouble.** Those who got convicted by the IRS was not because they took an aggressive position on a gray area or puffed up their charitable donations. It was because they did something unequivocally fraudulent (such as millions in unreported income.) Many areas of the tax law are gray. The gray areas are mainly with deductions. Therefore if you report all taxable income and you are legally & discreetly aggressive with your deductions, it is very unlikely you are going to get into any serious trouble with the IRS. With the IRS you do have rights! Your bill of rights is IRS Publication number 1, *"Your Rights as a Taxpayer"* Obtain the publication. It’s free. This leads us to number 4, next.

**B. MINIMIZE OR ELIMINATE IRS PROBLEMS WITH “THE TWO-WALL DEFENSE “. THIS ELIMINATES IRS FEAR!**

Two walls – *Audit Prevention* and *Automatic Pre-Audit Preparation*. With the castles of olden times, the ones that were the most invincible were the ones that had two walls of defense. The same holds true for your defense against the IRS. You need two walls of defense: *Audit Prevention* and *Automatic Pre-Audit Preparation*. Audit Prevention (or audit proofing) will reduce or perhaps even eliminate your return from being selected for audit. In case you are audited Automatic Pre-Audit Preparation is a back up wall of defense where you automatically have the documentation and tax law cites to support your Goldmine tax-reduction strategies.

**C. FIRST WALL IS AUDIT PREVENTION - USING STRATEGIES TO PREVENT OR REDUCE YOUR CHANCES OF AN AUDIT**

The first rule of tax reduction planning is not to get audited! Here are some audit proofing techniques:
1. **File extensions for all your tax returns.** You can minimize your chances of being audited by filing as late as legally possible.

(a) **Reasons why extensions reduce the chances of an audit** - An individual tax return filed around April 15 generally has a greater chance of being audited than one filed on October 15 (the latest possible date). This is because the IRS schedules audits more than a year in advance. As returns are filed and scored by computer, local IRS districts submit their forecasted requirements for returns with audit potential. The fulfillment is made from returns already on hand. If your 1040 is filed on October 15, there is a smaller chance that it will be among the returns shipped out to the District Office in the first batch. As a result of scheduling and budget problems that are likely to develop in the two years after your return has been filed, it may never find its way into the second batch slated for examination.

(b) **Other advantages** - Stops you from "rushing" to get your return finished which in turn could cause you to overpay taxes or get sloppy with your return causing an audit. *Haste makes waste!* They also extend the time up to the following October 15th to make tax-deductible contributions to certain retirement plans.

(c) **Extends time to file not pay, but well worth it** - Understand that filing an extension does not postpone the payment of any taxes you owe. (Pay in at least 90%). **This is not its purpose.** The purpose of the extension is to reduce your chances of an audit, stop the mad rush and extend the time to make tax-deductible contributions to certain retirement plans.

(d) **Forms and dates of extensions for individuals (1040)** - For individual extensions, file IRS form 4868 for an automatic 6-month extension from April 15 to October 15. If you owe, pay at least 90% with extension.

(e) **Forms and dates of extensions for entities** – The entities that follow file a separate automatic 5-month extension on IRS form 7004.
(1) **LLC or Partnership Form 1065**: Automatic 5-month from April 15 to September 15 (not October 15) using IRS form 7004.

(2) **Corporations (C or S) Form 1120/1120S**: Automatic 6-month extension from **March 15** to **September 15** (not October 15) also on IRS form 7004 (but **by March 15**, not April 15).

(3) **File on time** - File these partnership, LLC and corporate extensions before the above due dates, otherwise there could be costly penalties, even if the entity does not owe taxes.

2. **Avoid “E-File”!** *E-File* is filing your tax return electronically right into the IRS computers. While this process may be easier and more convenient, it can be dangerous to your financial health. Why? Would you place your head in the mouth of a lion? Of course not! When you do E-File with the IRS, that’s exactly what you are doing. You are making it very easy for them to chop your head off. Instead, file your returns the “old fashioned” way - *mail* in the computerized paper forms. *Reason:* With the paper forms, the IRS has to go through more effort to get to them, such as open the envelope, process the forms, etc. Somewhere along the way the paper may get internally misplaced or even lost. (It happens!) Therefore, your paper return may never make it to any audit pile, even though it may have had audit potential. On the other hand, the E-File returns are right there, first come, first served, for a possible IRS inquiry or an audit.

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 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 - A 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. As discussed in Chapter 5, LLC-partnerships give the best legal and tax benefits for real estate over any other entity.

**D. SECOND WALL IS AUTOMATIC PRE-AUDIT PREPARATION**
(a) **In general.** This is a system that will automatically prepare you for an audit in the unlikely event that one occurs (after using *Audit Prevention*).

(b) **More Specifically.** Includes being well organized and using my Goldmine system of special forms along with supporting tax law citations.

(c) **Implementation.** To employ *Automatic Pre-Audit Preparation*, refer to the Goldmine text for the tax law cites supporting your deductions and strategies. Also use the special *Goldmine* forms in the Forms Appendix of the SAP’s. Such forms are contained in certain applicable chapters that follow, where the particular form would pertain to the subject matter of the chapter.

**D-1. USING THE GOLDMINE TWO-WALL DEFENSE HAS THESE IMPORTANT ADVANTAGES**

1. **Rest better.** You will sleep much better, not worrying about the IRS (this alone is worth a lot!)

2. **Good detail.** You will develop good habits by being more attentive to detail using the system.

3. **Eliminate fear!** You will not be afraid to be more creative & aggressive in your strategies. This is in turn will save you even more taxes.

4. **More control.** You will have more control over your tax situation

5. **Right direction.** You will not be swayed in the wrong direction by inept or unconcerned advisors.

6. **Save legal fees.** You will save substantially on legal and accounting fees, especially for tax research. The Goldmine has already done it for you.

7. **End result.** You will pocket *much more* money, without fear of the IRS!

**E. KNOW YOUR RIGHTS AND HOW THE IRS WORKS**
1. **Taxpayers’ Rights.** As a taxpayer you have rights, which have been expanded under *The IRS Restructuring and Reform Act of 1998*. Taxpayers can sue the IRS for damages caused by an IRS employee who “recklessly or intentionally” disregards provisions of the code or regulations in connection with collecting taxes. You can collect attorney’s fees and related costs (such as expert witnesses) if you prevail in a case in which the court determines that the IRS acted without “substantial justification”. (Refer to IRS Publication 1, *Your Rights as a Taxpayer.*)

2. **Know the IRS hidden weaknesses.** In the event of an IRS audit, there are IRS “hidden weaknesses” that can help you. Use “time”. IRS auditors are under time pressure to close cases. They are rated by how many cases they close. So if your records are organized and you are persistent in your arguments on viable issues, the auditor may just want to move on to another taxpayer’s case.

3. **If necessary “appeal” your case to win.** If the IRS auditor is still not agreeable, you have a better chance of winning on appeal. Statistics show that the average results on appeal are a 40% reduction in taxes, penalties and interest. However, only one out of sixteen audited taxpayers goes to Appeals. The Appeals (or “Appellate”) level of the IRS is not a court, but an informal hearing with an “Appeals Officer”, who has a different job than auditors at the examination level. Their job is to settle cases and avoid the “hazards of litigation”, such as the cost of going to court and the IRS losing. Appeals officers have better credentials and training than office auditors. Thus, they have more power to negotiate a settlement of a tax dispute, considering the strength of the evidence. For more about the appeals process, refer to IRS Pub.1, *Your Rights as a Taxpayer.*
4. **Knowing your rights gives you more confidence.** Knowing your appeals rights from the outset of an audit can give you more confidence and strengthen your position throughout the audit. Again, IRS auditors are evaluated by how many cases they close. They therefore do not want your case to go to Appeals. Frequently, just by saying, “OK if you are going to play hardball, I got hard bats. Just write it up and I will settle this at Appeals.” This will have an impact on the auditor. They will know you know the rules and that you will not be easily intimidated. They would prefer that you not go to appeals.

5. **Knowing your rights from the outset and knowing how the system works, can have an impact on your taxes before you are ever audited (if, you are ever audited).** For instance, if you discreetly take aggressive positions on questionable areas of the tax law, you will know that you have a good chance of winning by actually going to Appeals (or by stating that you will go to Appeals), with the good possibility that the IRS auditor will back off, as per the above.

6. **Best is not to get audited in the first place, as per the audit-proofing strategies in this chapter, and others discussed throughout the Goldmine.**

Reference Source (return tab): **SAP 3**

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred,
reproduced by any means, stored in any information retrieval system or transmitted in
any form or by any means without the specific written permission of ISU. Legal action
will be brought against you and/or your company if you are found to have made ANY
unauthorized copies of these materials, in part or in whole. Unauthorized copying is
AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you
are committing a serious copyright infringement crime, punishable by severe fines and
imprisonment, and you may be held liable under BOTH civil and criminal law.
The way a building needs a solid foundation, so does your tax-reduction planning. This foundation is the essential fundamentals of reducing taxes. Besides IRS audit proofing there are these other fundamentals discussed in this chapter.

**A. GET ORGANIZED AND DO SUPERIOR RECORDKEEPING!**

**B. KNOW THE TAX LAW AS IT RELATES TO YOU**

**C. DO TAX PLANNING IN ADVANCE BEFORE DECEMBER 31**

**D. BE CREATIVE & AGGRESSIVE IN TAX REDUCTION PLANNING**

**E. AVOID INCOMPETENT TAX ADVISORS**

**F. DO NOT RUSH YOUR TAX RETURN**

**G. UNDERSTAND THAT IT’S NOT JUST THE TAX SAVINGS, BUT WHAT YOU CAN DO WITH THE TAX SAVINGS.**

---

**A. GET ORGANIZED AND DO SUPERIOR RECORDKEEPING**

**1. Do it frequently.** The *key* to superior recordkeeping (RK) is to it make it a good habit and do it as *frequently* as possible during the year. **STAY ON TOP OF IT!** Ideally it should be done every day or every week; at least every month. **Reason:** When you let it go until the year is over, the RK accumulates and takes much longer, at least twice as long. (“*A stitch in time, saves nine*”). That is, RK done frequently during the year will cut your RK time at least by one-half at the end of the year. So if you spend an hour a
month (or 15 minutes a week) on RK, it will save you at least 12 hours at the end of the year. That’s 12 hours you can use to make money in your business.

2. A tax reduction and business tool. Plus with RK, you are obtaining every possible tax deduction which is another way of cutting expenses (because “taxes” are one of your largest expenses). RK is a business tool as it tells you what works and what doesn’t work for your business.

3. Poor recordkeeping is costly! As Charles Shepherd found out. The tax court disallowed $47,170 of this salesman’s expenses because of insufficient substantiation (“a disorganized assortment of receipts”).

4. The best defense against IRS. Another plus, superior RK is the single best weapon in an IRS audit. (“An ounce of prevention is worth a pound of cure”). According to Pre-Paid Legal Services, well over one half of their members that kept good records got “no change” letters or even tax refunds when they were audited. Amen!

5. Burden of proof is still on you. In 1998 there was this, “Relief for Taxpayers - Burden of Proof Is On IRS”. This was a headline in major newspapers throughout the country in 1998. It proves that a little knowledge (or a little news) can be dangerous. First, the burden only shifts at the tax court. At the IRS examination level it remains with the taxpayer. Moreover, if your audit goes to tax court, to qualify for this shift of burden of proof to the IRS, certain conditions must take place: (1) You must maintain all records required by the Internal Revenue Code, (2) You must produce these records at the audit. Therefore, the IRS best defense is to reshift the burden back to you, the taxpayer, and assert that you did not have adequate records. (Failure to maintain adequate records can result in a 20% negligence penalty of the amount of tax attributable to the negligence.) Accordingly, many tax advisors expect to see even greater emphasis placed on record keeping by IRS agents.

6. Bottom-line is to keep excellent records. - Contemporaneous diaries, bills, invoices, contracts, third party documentation, QuickBooks, etc.

B. KNOW THE TAX LAW AS IT RELATES TO YOU
1. **It’s your money!** You need to at least have a general understanding of the tax law as it relates to real estate and to* your personal situation. You cannot just leave it up to professionals. Why? The majority of CPA's, accountants and tax preparers are not true tax specialists, let alone **Real Estate Tax Specialists**. This is further discussed under part E in this chapter.

2. **Leave it up to your advisors and you will be broke!** Saying the proverbial, "I leave everything up to my tax advisor” is like saying, “I leave all of my health-care up to my doctor”. If you did the latter you would be dead, and if you did the former you would be broke! Even a competent tax specialist cannot take care of your day-to-day needs. Tax laws have a **Dollar-Impact** on your everyday business activities.

3. **How to do it.** The way to gain a general understanding of the tax law is:

   - This course (that’s why you invested in it!)
   - Our member-only web site, **www.goldminevipaccess.com**
   - My other tax publications
   - Attend tax seminars that I will be giving in the future
   - Have a periodic review by a competent **Tax Specialist**.

**Alert:** Do not call the IRS for advice. They generally give you wrong costly answers to which they cannot be held accountable for. It’s on YOU!

**C. DO TAX PLANNING IN ADVANCE BEFORE DECEMBER 31**

*The beginning is the most important part of the work*. Plato.

1. **If you fail to plan you will plan to fail.** The failure to do advanced tax planning is a big reason why you unnecessarily pay too much taxes.

2. **Not tax preparation on April 15th.** Preparing your tax return for April 15th is *not* advanced tax planning. It is merely tax "compliance" as opposed to **Tax Reduction Planning by Choice**. Successful entrepreneurs plan **first** and comply later.
3. There are many surprises every April 15th and most of them are not good! In fact, many are financial disasters all because the taxpayer did not take the time to implement a plan before December 31. Such disasters could be avoided with advanced planning.

4. Misconceptions about advanced planning. Many people have the costly misconception that tax laws are simple or that the complex ones only pertain to the "rich". It is true that the "rich" do plan, but advanced planning is how they got to be rich in the first place. (Remember, it’s not what you make, it’s what you keep!) Others have the misconception that if they are having a bad business year, then there is no need to do advanced tax reduction planning. As discussed in Chapter 28, an important part of tax reduction planning is not wasting deductions or making certain elections to take advantage of unused deductions in the future or even carry them back to prior years. Successful Entrepreneurs always need to plan in advance, before December 31!

5. How do you do advanced planning? Adhere to the multitude of advanced Goldmine strategies in this publication. When using the Goldmine, if you deem necessary, engage competent tax advice to periodically review your tax situation especially before you enter into any financial transaction that could have a significant tax consequence.

D. BE “CREATIVE” & “AGGRESSIVE” IN TAX REDUCTION PLANNING

1. 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. “The idea is there, locked inside. All you have to do is remove the excess stone”. - Michelangelo.

2. Creative. 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 frequently be attained by the imaginative structuring of real estate transactions. That is, tax saving opportunities can be attained in so many ways, provided you apply creativity to the situation. The best way to be creative is to follow the Goldmine tax reduction system.

3. **Aggressive.** A partial dictionary definition of the word *aggressive* is “vigorously energetic, especially in the use of initiative”. Therefore, being aggressive is not 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, much of the tax law is gray and involves many arbitrary questions of *fact* and subject to controversy. It is in these controversial areas that you can be legally & discreetly aggressive and structure tax transaction in your favor. 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".

4. **Goldmine documentation.** The key to successful aggressive tax-reduction planning is to fully document your transactions with tax law citations and employ audit-proofing techniques. This is exactly what the Goldmine does.

E. AVOID INCOMPETENT TAX ADVISORS

**Bad advice is very expensive!** One of the biggest reasons (if not the biggest) why real estate investors pay too much taxes is bad advice from inept or overly conservative tax advisors or CPA’s. An article in *Money Magazine* revealed that 50 different tax preparers were given the same family’s financial records. *The Result:* 50 different 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! Moreover, in most cases fees were fairly
The February 1980 issue of Money Magazine also did an article titled, “Whose Side Is Your Tax Preparer On?” In many cases, it’s not yours!

1. **80-15-5 rule**. Know that 80% of tax advisors are incompetent; 15% pretty good and 5% superb. There’s an 80% chance you have the 80, see next...

2. **Avoid bad tax advisors (80%)**. They will cost you thousands. The 80% do not what to learn new tax savings ideas; think they know it all; have little or no knowledge about real estate; self-serving and are either overly conservative, or extremely sloppy (both of which will cost you money or get you trouble)

3. **Consider very carefully selecting the 5%**. They are the best and have it all, but may be difficult to find; too expensive and controlling. Unless you are a big player or have a major tax problem, the 5% may not be for you.

4. **Consider selecting the 15%**. They have a good *attitude & aptitude*; are willing to learn with you sharing the Goldmine; are genuinely concerned about saving you money; and should be less expensive. They are responsible people who have positive qualities of integrity, dependability and professionalism.

5. **Get names of prospects with references**. From fellow investors, investor associations, attorneys, banks, etc.

6. **Call the references**. Ask *specific* questions about the CPA- prospect as to how they help save the reference source money and did they give good service.

7. **Call the prospective advisor(s)**. Introduce yourself as a real estate Investor and ask if they serve other real estate investors. Quickly test their knowledge with a question or two. Examples - You are thinking of selling a property, ask - *what can you do to help me avoid paying capital gain’s taxes?* Or, *can you advise me on how to increase deductions on my rental properties?* Expect positive answers or move on.

8. **Other follow-up questions**. Ask about what audit proofing they do; their credentials; do they *plan* your taxes and not just “prepare”.
9. Ask about fees last after the interview is over. Flat fees are better than hourly. Don’t get ripped off; but value first, price later.

10. Have a written agreement with the advisor. Outlining services covered, not covered, fees, copies of all “back-up” schedules, termination, etc.

11. Consider using an advisor only on an as needed basis. Such as a one-time set up and preparation of your tax return. Any remaining services on an as needed basis for complex situations or tax return reviews every three years

12. Do NOT limit yourself to someone local. This is a frequent BIG mistake, especially with tax specialists. With today’s technology, don’t let physical distance get in the way of money-saving advice.

13. Use a qualified bookkeeper to save time & money. A good local bookkeeper can do much of the work a CPA does, but at much lower fees.

14. Evaluate your present tax advisor. Share the Goldmine with them, screen them out and fire them up, or fire them ASAP.


F. DO NOT RUSH YOUR TAX RETURN

Another IRS weapon. Besides FEAR, the IRS has a little known second weapon - RUSH! April 15th is not enough time to really take your time and properly plan and prepare one of your most important financial transactions - your tax return. Remember "Haste makes waste!" It increases your margin of
error, will costly you dearly and this is exactly what the IRS wants. Tax advisors are extremely busy from January to April, working long, tiring and tedious hours. You do not want a tax preparer in a clogged state of mind to work on an important financial transaction such as your tax return. Here is what to do:

1. **Do daily recordkeeping** throughout the year to keep your financial data updated

2. **Do advanced tax reduction planning**, before the end of the year (see part C in this Chapter).

3. **Get to your tax advisor early** in the year (if you have one).

4. **Never accept a final processed copy** of your tax return without having a “preliminary draft” that you can take your time with to carefully review.

5. **File an extension.** The extension STOPS YOU from rushing to get your return finished. You, or a much more composed tax advisor, can take the time to ensure that you have maximized tax savings and minimized IRS problems.

**G. UNDERSTAND THAT IT’S NOT JUST THE TAX SAVINGS, BUT WHAT YOU CAN DO WITH THE TAX SAVINGS**

Take $1 double it tax-free for the next 20 years it grows to $1,048,576; the same $1 taxed at 35% grows to only $22,370... *A LOSS of MILLION DOLLARS!* Sooner is better than later and more is better than less. With the reinvestment of the savings you get both – sooner and more!
1. **Fundamental to achieving wealth.** Saving taxes is *foundational* to wealth building! Taxes are a primary factor in determining whether you get rich or stay poor. For example, suppose you’re able to save $1,500 a year. That’s $37,500 over the next 25 years! Imagine what you could do with an extra $37,500.

2. **A BIG expense.** Taxes take more of your income than many of your other expenses *combined!* The average American saves only about 4% of their gross income? Not just because of foolishness or lack of dedication to saving, but because that’s all that’s left! The government gets first choice on more than half of what you earn. You get the leftovers. They take half or more of what you earn and leave you with what’s left to live on – to pay for a home, food, clothing, your kids’ education, doctor bills, car bills, medical insurance, appliances, repairmen, laundry, shoes, aspirins, legal bills, tires, Christmas gifts......No wonder you can’t save any money!

3. **Example.** Let’s say you’re able to save just $2,000 annually on your tax bill. (With the *Goldmine* it will be even higher). You invest that $2,000 in an IRA or some other financial instrument that earns a tax-deferred return of 10% annually. After 20 years, you’ll have over $114,000! If you can save $10,000 annually on your tax bill for 20 years, you’ll end up with almost $573,000! With the $10,000 you can also buy a bargain property which you quickly flip for a $5,000 clear profit, or a nice 50% return on the use of the tax savings. Of course, you can continue to use and snowball the accumulated funds into more profitable investments.

4. **Enjoy life too.** You can also use the tax savings to change your lifestyle and improve your standard of living - luxury car, second home, fancy restaurants, more vacations, etc.

5. **You have tax-saving power with the Goldmine.** Most people think of taxes as something that cannot be avoided – the government says pay, so you pay. You would like to pay fewer taxes, but you don’t actually do much
about it because (a) you don’t think there’s much you can do; or (b) you don’t think anything you can do actually would make a difference. Wrong! Not with the *Goldmine*! It gives you *tax-saving power*!!

**6. Plus you can recoup past paid taxes as refunds in your pocket.** For most missed deductions or strategies, you can file an amended return back to recoup those lost tax dollars, plus interest. Contrary to public thinking, amended returns generally do not trigger audits. Many are processed routinely.

**MORE INFO:** For more on filing amended returns see SAP 35. We can also refer you a competent tax professional specializing in properly doing amended returns. Email us at taxbible@aol.com with your R-GM VIP code.

Reference Source (return tab): **SAP 5**

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
How To Reap More Deductions By Considering Your Real Estate To Be a “Business”, And Not Just An “Investment”

A. THE ENTREPRENEURIAL VIEWPOINT

B. TAX VIEWPOINT -- THE ADVANTAGES OF BEING CONSIDERED A BUSINESS ARE MORE DEDUCTIONS

C. IS REAL ESTATE IS A “BUSINESS”, NOT JUST AN “INVESTMENT”

D. STRATEGIES TO MAINTAIN REAL ESTATE AS A BUSINESS:

E. AVOID THESE MISCONCEPTIONS WITH REAL ESTATE AS A BUSINESS

A. THE ENTREPRENEURIAL VIEWPOINT

From an entrepreneurial viewpoint, real estate is both a business and an investment. It’s a business because it requires the owner to be expertised in the many facets of real estate such as acquisition, negotiation, finance, taxation, management, marketing etc. It’s an investment because it entails investing so much resources for an anticipated return.

B. TAX VIEWPOINT -- THE ADVANTAGES OF BEING CONSIDERED A BUSINESS ARE MORE DEDUCTIONS
However, from a tax viewpoint, it is much more beneficial that real estate be considered a “business” and not just an “investment”. Being considered also a business will give the property owner these advantages over being considered just an investment:

1. Eligibility to deduct start-up expenditures (See Chapter 10-A).

2. Eligibility to deduct Section 179 first year expensing in certain situations (Chapter 13)

3. Better eligibility to deduct depreciation in certain situations (Chapter 15).

4. Better eligibility to claim interest expense (Chapter 22).

5. Eligibility to fully deduct operating expenses on rental or business schedules as opposed to miscellaneous itemized deductions, where there are limits (Chapter 23).

6. Eligibility to fully deduct expenses for a convention, seminar or similar meeting (Chapter 23).

7. Eligibility to take advantage of certain fringe benefits, such as a Medical Reimbursement Plan under IRC 105(b).

8. Eligibility to fully deduct rental property losses with less or no limitations (Chapters 25, 26 & 27).

9. Better eligibility to fully deduct losses on the disposition of the property without any limitations (Chapter 44).

C. IS REAL ESTATE IS A “BUSINESS”, NOT JUST AN “INVESTMENT”

1. A Business. Rental real estate has generally been considered to be either a business under IRC 162 and/or held for the production of income (investment) under IRC 212. Overall, there is much more of a tendency to treat real estate as a “business”, and stocks just as an “investment”.
2. Tax law support. In addressing start-up expenditures under IRC 195, the Senate Finance Committee Report has stated that income-producing real estate is generally considered to be an active trade or business. According to a number of cases, the rental and management of an apartment building or residential property amounts to a trade or business, even where an agent acts for the owner, Elek, (1958), 30 TC 731(A); Reiner (1955, CA7) 222, F2d 770; Wachter, 12/13/74, DC-WA, 35AFTR. The taxpayer was ruled to be engaged in a trade or business, because `when they purchased the rental property, they listed it for rent with a broker and showed it to prospective tenants. Even though they failed to rent it, they still were considered to be in a business, Jephson (1938) 37 BTA 1117.(underlined emphasis added). IRS permitted a partnership to deduct operating expenses as business expenses on an office building during an 8 month period in which tenants were vacated and the building renovated before old and new tenants moved in, PLR 7931008. IRS Publications 527 and 946 state that you can claim the Section 179 deduction if rental property is your trade or business. (Emphasis added)

3. The final analysis. Here is how I see it. If you actively manage your property enough to meet the $25,000 passive loss exception (Chapter 25), your rental property should be considered a “business” as well as an “investment”. If you materially manage your property enough to meet the active business-use test to totally bypass passive loss limits (Chapter 26), your rental property should definitely be considered a “business” and not just an “investment”. On the other hand, passive real estate investments, such as an interest in a limited partnership or a REIT (Real Estate Investment Trust) will be pure “investments”. There is uncertainty about net lease properties (where less management is required). They may be more akin to being a pure “investment” and may lose some of the above advantages. However, this is not totally certain. In most cases, land will be a pure investment and not a business. But for the most part, real estate is a business.

D. STRATEGIES TO MAINTAIN REAL ESTATE AS A BUSINESS:

1. Use a business entity – an LLC. A properly structured LLC with complete LLC forms (esp. the operating agreement) can document your real
estate activities as a *business*, supporting a multitude of tax deductions and strategies. (Ask about our new LLC Forms Package – taxbible@aol.com)

2. **Run it like a business.** Keep good separate business records and use a separate business checking account, which should not be used for personal expenditures.

3. **Be active.** Actively manage the property. (See ch. 25 and esp. ch. 26)

4. **Business plan.** Write a business plan stick with it, review & update it periodically. Engage professional advice and pursue a business to really make money.

5. **Lease the property at fair rental value.** Do so with arm’s length written lease documents.

6. **Intent for profit.** If the property is not rented, document attempts to rent it by way of newspaper ads, “for-rent” signs, listing for rent, flyers, the internet, etc. (See Chapter 15 for a further discussion.)

7. **Get educated.** Attend seminars and buy publications on real estate. Continue to do this. *If you think education is expensive, try ignorance.*

8. **Continue to buy more properties in your LLC.** The more properties that you own, the more you are in the real estate business. (If you buy them right, you will also make a lot of money!)

**Make money, save taxes.** The above will make you more money besides saving taxes (which is also money!)

**More Info.** See Chapter 27, part A.

---

**E. AVOID THESE MISCONCEPTIONS WITH REAL ESTATE AS A BUSINESS**
1. You do \textit{not} have to file IRS Schedule C for real properties to be a business. This is so even if you are an active real estate entrepreneur and \textit{not} subject to passive loss limitations as per Chapter 26. \textbf{Stay off IRS Schedule C.} You can file Schedule E, or even much better IRS Form 1065 - a partnership return. Such partnership returns are audited less than Schedule E’s or C’s. LLC’s with two or more members file form 1065 partnership return.

2. Rents for the use of property are \textit{not} subject to self-employment (social security) taxes. IRC 1402 (a)(1). This is so regardless of the number of rentals that are owned.

\textbf{NOTE:} Security deposits are \textit{not} taxable. This is so provided that the payment is for the security for the performance of the tenant’s obligation and is to be refunded in accord with the lease in the absence of default, \textit{George E. Barker Estate}, 13 BTA 562. They are still not taxable, even if the landlord does not segregate the funds and even uses the funds for their own purposes, \textit{Warren Service Corp.}, 110 F.2d 723. (They do become taxable when they are forfeited by the tenant as compensation for damages.)

3. Don’t confuse \textit{“business-use”} property with \textit{“dealer”} property”. They are different tax categories with different tax consequences as follows.

(1) \textit{Business-use property} - This is property you rent out to others as an investment. Also included are hotels, motels and property that you own and use in your own business, such as an office building for your own real estate company or a plant for your manufacturing operation. This category use has to do with the \textit{operations} of the property, not selling. You intend to \textit{hold} this property and \textit{not} sell it (at least for a while). Unlike dealer property, with business-owned real estate you are entitled to tax advantages such as depreciation deductions, lower capital gain rates and the eligibility to defer taxes on the sale of the property via a 1031 exchange or installment sale reporting under IRC 453.
(2) **Dealer property** - On the other hand “*dealer*” property is property that is held as “inventory” for immediate sale to customers. IRC 1221(1). It’s like “widgets” on a shelf waiting to be sold. This use has to do with *selling*, not operations. You will *sell* and *turnover* this property as quickly as possible and *not* hold on to it.

(2A) **Dealer property has these tax disadvantages** - Dealer profits are taxed higher as ordinary income. Because it is active income, dealer profits could also be subject to social security taxes at about 15%. Moreover, dealer property is not entitled to depreciation deductions and dealer profits cannot be tax deferred by using a 1031 exchange or by taking back financing via installment sale reporting under IRC 453. Also, you cannot use a self-directed IRA to shelter dealer profits.

(2B) **But not a clear-cut issue** - Whether a property is an “investor” property versus a “dealer” property is far from clear-cut and with planning dealer status can be totally avoided saving you thousands. For a further discussion see Chapters 6, 41, 42, 43-A and Appendix E (PAPPE).

Reference Source (return tab): SAP 1

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
This chapter will cover the following entity structuring basics...

**A. LOOK AT BOTH THE LEGAL AND TAX SIDE OF ENTITIES**

**B. QUICK OVERVIEW OF THE STATUTORY ENTITIES**

**C. GENERAL RULES OF ENTITY SELECTION FOR RE INVESTORS**

---

### A. LOOK AT BOTH THE LEGAL AND TAX SIDE OF ENTITIES

The three main types of state-registered entities are

1. Limited Liability Companies (LLC’S)
2. Limited Partnerships (LP’S)
3. Corporations (C or S).

Essentially there are two sides to these entities: (1) The LEGAL side and (2) The TAX side.

**1. LEGAL SIDE:** The legal side is governed by state statute. On the legal side, with the proper entity formalities, these entities all accomplish essentially the same thing – they give the entity owners limited liability and thus protect their personal assets outside of the entity. So the legal is the legal and does not vary that much.

**2. TAX SIDE:** The tax side is governed by a much wider more complex body of federal & state tax law where these entities could vary greatly as to their tax consequences with dollar-saving benefits or costly detriments, depending on which entity is selected. 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 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, the tax side has subcategories such as IRS Audit Proofing where certain entities are audited less than others. Here, you need to stay updated on which entities are on the IRS hit list (discussed in Chapter 5). Armed with this information, if you use the high audit-profile entity, you do the entity structuring correctly along with IRS audit proofing; or you use another entity if this other entity is just as effective but a low-audit profile. This will be discussed in the ensuing sections.

3. BOTH SIDES - LEGAL & TAX: You have to look at the total picture and look at both sides (with generally more emphasis on the tax side). This two-sided approach is fundamentally important to understanding entity selection & structuring.

EXAMPLE: For your properties, you form an LLC-partnership. That is, on the legal side, you form the LLC for limited liability protection. On the tax side, you elect the LLC to be taxed as a partnership giving you 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 (discussed in the next chapter).

NOTE: Because it is a tax publication, the focal point of the Goldmine is the tax side of the entities.

B. QUICK OVERVIEW OF THE STATUTORY ENTITIES

1. LIMITED LIABILITY COMPANIES (LLC’S): 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 some of the major legal advantages of corporations and the excellent tax advantages of general partnerships. The owners in an LLC are called members or managers.

   (1) Legal Status: The legal rights and obligations of members, are governed by the applicable state LLC statutes (like corporations). The first LLC law in
the United States was enacted in 1977 in Wyoming. Presently all 50 states and the District of Columbia have enacted LLC statutes. Many states have modeled their statutes after Wyoming. Most states allow single-owner (member) LLC’s (not recommended as later discussed). As with corporations, LLC laws vary from state to state.

(2) Tax Status: 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 and thereby be governed by the favorable tax benefits of partnership tax law.

2. PARTNERSHIPS: A partnership is an association of two or more legal persons (or entities) joined together in a business.

(1) Legal Status: In a general partnership each general partner is both jointly and severally liable for all debts of the partnership (except for nonrecourse debts). General partnerships are very inexpensive and simple to form. There are generally no state filings. They can be done informally and verbally (although not recommended).

Because of liability exposure, general partnerships are not recommended. Use either LLC-partnerships (Chapter 5) or in certain limited situations, limited partnerships (Chapter 7).

(2) Tax Status: Partnerships are governed by Subchapter K of the Internal Revenue Code. They are separate tax entities and file IRS form 1065. But partnerships do not pay taxes as an entity. Instead income, deductions, losses & credits pass through to the partner’s individual tax returns, via a partner K-1 form. They are pure flow-through entities. Partnerships became even more attractive when the 1986 Tax Reform Act disallowed the tax-free liquidation of corporations (known as the “General Utilities” doctrine). As pure-flow through entities, partnerships have enormous tax benefits for
real estate (including tax-free liquidations) far superior than corporations as discussed in this section.

3. LLC-PARTNERSHIPS: An LLC-partnership is both a legal entity and a tax entity with at least two members. In most cases the LLC-partnership will be the ideal entity preference for real estate ownership. They are generally the best for real estate.

(1) Legal status: On the legal side the LLC-partnership has the corporate structure of an LLC giving its owner-members limited liability protection, protecting member personal assets.

(2) Tax status: On the tax side it is a partnership with the favorable tax benefits of partnership tax law, including a lower IRS audit profile.

4. LIMITED PARTNERSHIPS (LP’S): An LP is a separate legal entity formed under state limited partnership statutes with at least one general partner and one limited partner.

(1) Legal status: On the legal side there is limited liability for the limited partners, but personal liability for the general partner (GP), unless GP is a corporation or LLC.

(2) Tax status: On the tax side an LP is a pass-through entity, filing partnership tax forms and has almost all of the same partnership tax advantages. But, unlike LLC members or general partners, 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. LP’s are discussed further in Chapters 7 and 7A.

5. CORPORATIONS: A corporation is a legal, artificial person that is separate, distinct and apart from the owners.
Legal status: All corporations are created by filing incorporation papers with the secretary of state (the state of the corporation). Corporations give its shareholders limited liability protection.

Tax status – C and S Corporations:

(a) **C-corporations** - Taxwise 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. It is therefore taxed separately as an entity with an upper tax rate of about 40%. A C-corp files IRS Form 1120.

(b) **S-corporations** - Again all corporations start as a C-Corporation, but may make a written and timely election (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 (within certain limits) pass through to the shareholder’s individual tax returns, via a shareholder K-1 schedule (somewhat similar to partnerships). S-corps offer the same limited liability as a C-corp, yet do not have the disadvantage of double taxation. An S-corp files IRS Form 1120S.

(c) **Corporations overall are for businesses, not real estate** - Corporations are designed for businesses *not* involving the ownership of real estate and have costly disadvantages for real estate, discussed in the next chapter.

C. GENERAL RULES OF ENTITY SELECTION FOR RE INVESTORS
1. **LLC’s** – Use LLC-Partnerships for real estate investments as per Chapter 5. On a very limited basis use limited partnerships (LP’s) as per Chapter 7.

   (a) **With land trusts** - For more privacy, you could use land trusts in conjunction with an LLC with the land trust holding legal title and the LLC as the beneficial owner of the land trust. See Chapter 7-B.

2. **Corporations (C or S)** - For businesses not involving the ownership of real estate.

   (a) **C-corp’s with real estate only as a minority member** - Real estate investors should only use corporations in a secondary role, not as a primary entity for real estate. For example, to take advantage of certain C-corp fringe benefit deductions, instead of making the C-corp the primary entity owner of the real estate, or a management company; make the C-corp a minority non-voting partner of a real estate LLC or a low percentage general partner in an LP. This is further discussed in Chapter 5-B (LLC’s) and in Chapter 7-A (LP’s).

   (b) **S-corp’s almost never** - Rarely (if ever) use S-corporations for real estate. The “S” stands for small business and that’s what S-corporations are for small businesses, not real estate (except possibly as a general partner in a limited partnership as discussed in Chapter 7-A).

3. **Trusts** - Estate planning trusts for personal property (such as an ownership interest in an entity like an LLC); for personal-use property (such as your home); for paper\financial assets (such as stocks or notes). Trusts should be used in conjunction with state statutory entities, such as LLC’s. Trusts are discussed in Chapter 8.

Reference Source (return tab): **SAP 1, Part A**

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW
Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Entity Protection - Avoid Owning Property Personally in Your Name - Convert from Single Owned IRS Schedules to a Partnership (Form 1065)

Reference Source (return tab): SAP 1, Part A

In this chapter we will cover the following...

A. CONVERT FROM HIGHER AUDIT-PRONE SCHEDULE “E” TO A LESSER AUDIT-PRONE PARTNERSHIP EVEN IF YOU ARE A SOLE OWNER
B. ALERT ON HUSBAND & WIFE PARTNERSHIPS WITH SPOUSAL MEDICAL REIMBURSEMENT PLANS
C. FOR BETTER ASSET PROTECTION, YOU LATER CAN CONVERT A GENERAL PARTNERSHIP TO AN LLC-PARTNERSHIP

Whether it be a keeper or flipper, avoid owning any property as an individual (singe proprietor) or as a joint venture (such as tenants-in-common or joint tenants). Reason:

While the above types of ownership are simple, they have these significant disadvantages:

1. Legal Side - Personal Liability for debts, obligations and torts. For real estate you could avoid personal liability by holding your properties in an LLC or sometimes in a limited partnership (LP).

2. Tax Side - High Audit Risk. Because they file IRS Schedule E (or Schedule C), individuals and co-tenants are more prone to IRS audits. According to IRS expert, Al Brindisi (CPA) Schedule C’s and Schedule E’s are audited the most, while partnerships (IRS Form 1065) are audited less. (See below).

A. CONVERT FROM HIGHER AUDIT-PRONE SCHEDULE “E” TO A LESSER AUDIT-PRONE PARTNERSHIP EVEN IF YOU ARE A SOLE OWNER
1. **Audit-Proofing** - Partnerships, filing form 1065*, are audited less than other business types. (*Form 1065 is filed for general partnerships, LLC-partnerships and limited partnerships).

2. **Establishing a partnership even if you are a sole owner** – 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 (See Chapter 5-B). 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 partnership or LLC operating agreement. This can be done after you acquire the property. It may be a little bit of trouble to do this, but only at first and well worth it when you consider that, according to recent IRS statistics, it will reduce your chances of an audit by 300% to 400%. Plus there are many other benefits to partnership tax law as discussed in the next chapter.

3. **How to convert from Schedule E to form 1065**: For your partnership apply to the IRS for a separate federal identification number, using IRS Form SS-4. You then use IRS Form 1065 to report your rental property income and expenses. The bottom-line partnership income or loss is carried to your individual 1040 return via a partnership schedule K-1. If you were previously reporting income and expenses on page 1 of Schedule E, then for the year of change make this statement on page 1 of Schedule E...

   *Effective January 1, 20XX, this business activity has been converted to a partnership under the tax-free provisions of Internal Revenue Code Section 721. All income and expenses are properly reported on IRS Form 1065 in accord with Internal Revenue Code Sections 701 to 704. The partnership has applied for a*
separate tax identification number. The partnership net taxable income or loss is reported on page 2 of this Schedule E.

**B. ALERT ON HUSBAND & WIFE PARTNERSHIPS WITH SPOUSAL MEDICAL REIMBURSEMENT PLANS**

1. **Spousal Medical Reimbursement Plan (MRP)** - A MRP is an employee fringe benefit that allows a business (including real estate) to fully deduct medical insurance and out-of-pocket medical costs as a *business* expense instead of being limited on Schedule A (Itemized Deductions). A spousal MRP is where one spouse hires the other spouse as an employee of their business, entitling the spouse-employee to this family fringe benefit deduction. But husband & wife partnerships do not qualify for this benefit.

2. **H&W Partnerships Do Not Qualify For MRP** – Therefore if your spouse is an employee under a spousal medical reimbursement plan (MRP) under Section 105(b), do NOT change to a husband & wife partnership. That is, you can have a partnership of two or more legal persons or entities, but not a husband and wife partnership for a spousal medical reimbursement plan.

**C. FOR BETTER ASSET PROTECTION, YOU LATER CAN CONVERT A GENERAL PARTNERSHIP TO AN LLC-PARTNERSHIP**

1. **Also LP’s can be converted** - Limited partnerships (LP’s) can also be converted to LLC’s. (LP’s have a limited use for real estate as per Chapter 7)

2. **Income tax-free** - These *non-corporation* conversions are free of income taxes and you can use the same federal ID number.

3. **Corporations\taxable** - Be alerted that corporations, with appreciated property, converting to an LLC will be a taxable event, even though no cash is realized.

For setting up your LLC-Partnership, see the next chapter.
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. LEGAL SIDE

For LLC’S, there is the following on the legal side:

1. **File Articles of Organization** with the Secretary of State of the LLC formations state. Just the legal set-up; tax elections are done with IRS, covered later in this part under tax side.

2. **The State Where Your Properties Are Physically Located Generally Should Also Be the Formation State for Your Real Estate LLC.**

   (a) **No state income tax savings** - Unless you own properties there, you generally do not want to use Delaware (or Wyoming) for the real estate LLC. *Reason: First off, using Wyoming will not save you state income taxes because if your property is physically located in the state with the income tax, then property taxable income is taxed in that state. This is because there is a link or nexus from the property to the state of its physical existence. With the flow-through LLC-partnership the state income tax liability flows first to your federal 1040 and then to your individual home state tax return (unless your home state does not have an income tax such as Florida). Otherwise, you still have this taxable flow-through even if you have a bank account in the other state such as Wyoming (or Nevada or Florida).**

   (b) **Does not really protect you** - If you want to use Delaware for its more favorable LLC statutes (especially privacy) you still have to register the
Delaware LLC as a foreign entity with the Secretary of State in the other non-Delaware state to qualify to do business in this other state where you physically own property. Plus if there is a legal action concerning the property, the state or locale of the property’s physical location will most likely have jurisdiction as opposed to the outside state such as Delaware. Wyoming and especially Delaware are considered to be superior states than Nevada for LLC’s. But again you generally should use the state of the property’s physical location.

3. For Your LLC (or Any Other Entity) Use a Fictitious Name. Example - *Diversified Property Associates, LLC*. Do not use your name, initials or any derivative thereof. *Reason*: More privacy.

4. Execute the LLC Operating Agreement. All of the members are to execute the LLC operating agreement which governs the financial and management rights of the members. The operating agreement is a private document that should not be made available to the public.

5. Avoid Piercing of Your “LLC Veil” By Adhering to Formalities. Failure to adhere to certain formalities could cause loss of the limited liability protection of an LLC (or corporation). There are 21 such formalities. Some examples are: Properly identify the LLC by having the full name on all documents, separate business bank accounts including no commingling with personal funds; properly identify the members with their titles as “Managing Member”; conduct regular documented meetings of the LLC members; timely & properly file all federal, state and local tax returns.

6. Be Alert About Any Local Transfer Taxes on Existing Property Transfers. Some states or locales may impose a transfer tax when transferring *existing* property to an LLC (as well as other entities). If this is
the case check with an attorney or title company to ascertain if there are any exemptions or legal ways to avoid such transfer taxes, (especially if they are significant). One possible way is to transfer the property to an intervivos trust, such as a land trust, and then privately amend the trust to change the beneficiary from the individual investor to the LLC.

7. Be Alert About Any Lender Policies as To Holding Property in The Name of an LLC. Mortgage lenders may require you to take title to a property in your personal name(s) and not in the legal name of the entity (such as an LLC). If the property is not titled in the name of the above types of entities, then you will be personally exposed to personal liability and thus defeat the legal purpose of the entity - limited liability. To bypass this here are some suggestions:

(a) **Transfer property after** - If there are little or no transfer taxes, sometime after the closing, transfer the property to the entity and have the entity take the mortgage* subject to, taking over the payments. Here you should incorporate in the LLC operating agreement that the LLC entity is taking the mortgage subject-to. With this subsequent property transfer, if there are substantial transfer taxes, see 6 above.

[*NOTE: Such a transfer will almost never trigger the due-on-sale clause, esp. a transfer to an entity and the LLC entity timely makes the mortgage payments.*]

(b) **Negotiate with the lender** - Inform them that by protecting your personal assets, you are protecting their interests as well. Moreover, if you (and perhaps others) are signing personally, then they are protected even further. (One of the great advantages of real estate investing is that *everything* is negotiable.)

(c) **Look for other lending sources** - If they will not agree, then don’t deal with these types of lenders who handcuff you with stupid rules. Generally,
for investment properties, you want to avoid residential conforming lenders who sell their mortgages to the secondary market. They have the most restrictions. Look for the many other sources. Examples: Nonconforming lenders, small friendly banks, aggressive mortgage brokers. While this is not a course on creative financing, other sources: Seller financing (best bank in town), subject-to’s, credit lines, credit unions, private investors (including their self-directed IRA’s).

(d) **Zero interest loans** - For lenders who lend to LLC’s, including those with zero interest loans, email us at taxbible@aol.com for our special report or check out our Goldmine Member Only Web Site – [www.goldminevipaccess.com](http://www.goldminevipaccess.com) click to the **green banner**. Call us if you have a problem 215-271-1998.

**NOTE:** Because it is a tax publication, the focal point of the Goldmine is the tax side of entities, such as the LLC. Accordingly, the above was a legal overview, but see below for more information.

**MORE INFO:** For more information on setting up real estate LLC’s with the correct documents (including a powerful 121 page real estate LLC operating agreement), refer to our new course, *The LLC Master Machine Forms Package* by Albert Aiello, CPA, MS Taxation with William Noll, Esquire. For more details see [www.LLCProtectYOU.com](http://www.LLCProtectYOU.com) or call us at 215-271-1998.

---

**B. TAX SIDE**

**For LLC’S, there is the following to do on the tax side:**

1. **EIN Number (Fed ID).** Obtain an EIN number by filing form SS-4 with the IRS (which could be done on the internet at [https://sa2.irs.gov/sa_vign/newFormSS4.do](https://sa2.irs.gov/sa_vign/newFormSS4.do)).
To download IRS form via the internet, go to https://www.irs.gov/formspubs/lists/0,,id=97817,00.html. You can also call for IRS forms or publications at 1-800-829-3776. If you want to fax the SS-4 call your local IRS office.) You need a separate ID for each new entity you set up.

2. Electing the Partnership Tax Status of an LLC (IRS Form 8832).

(a) Electing tax status - While legally it is a distinct legal entity, for tax purposes an LLC is not a distinct tax entity, until you decide. Under simplified “check the box regulations”, these regulations (Reg. 301.7701) permit a simple choice of tax entities as follows:

<table>
<thead>
<tr>
<th>Number of LLC Members</th>
<th>Tax Entities and IRS Forms to File</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single-member owned LLC’s</td>
<td>As sole proprietors on IRS Schedule C or E</td>
</tr>
<tr>
<td>Two or more member LLC’s</td>
<td>As a partnership on IRS Form 1065*</td>
</tr>
<tr>
<td>Any number of LLC members</td>
<td>As a corporation on IRS Form 1120.</td>
</tr>
</tbody>
</table>

(b) On IRS Form 8832 elect your real estate LLC to be a partnership. On form 8832 you check off the following two boxes: Part 1 Type of election, check box “a”, “Initial classification by a newly-formed entity. Part 2. Form of entity, check box “b”, “A domestic eligible entity electing to be classified as a partnership.”

Note: by default, a two or more member LLC is a partnership filing the lower audited form 1065. Therefore, a two or more member LLC does not have to file form 8832 election. However, for a two or more member partnership file the 8832 anyway so there is no uncertainty both on a federal and state level. You can download form 8832 from the IRS website at www.irs.gov.

NOTE: You elect the partnership tax status with IRS on form 8832 after the LLC set up, not with the state of the LLC formation. Such partnership tax status with IRS should also be in your LLC operating agreement, a private document.
3. Do NOT Elect the Real Estate LLC to be a Corporation (C or S) because of the Corporate Tax Disadvantages for Real Estate discussed in the next chapter.

4. Do NOT Have the Real Estate LLC be a Single Member LLC. 
Reasons: Taxwise, a single-member LLC files Schedule C for a business not involved in the ownership of real estate and Schedule E for investment real estate. But both Schedule C’s and E’s are audit prone schedules and thus should be avoided. Partnership form 1065 is much less audit prone. Legally, a single-member LLC is more apt to have its veil pierced and in most states does not get charging order protection for a membership interest. (Charging order protection is discussed in Chapter 7-A.)

5. You Can Create a Partnership Even if You Are a Single Owner. 
Another member (or other members) could be your spouse, other family members; or even better another entity that you own such as a trust, another LLC or a C-corporation*. (A revocable living trust would not qualify, and legally it is not a good idea anyway). You could also have an outside 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. (*See Ch 5-B for using a C-corp as an LLC partner-member). These additional member-partners do not have to be on the property title or on the mortgage. You add them as members in the LLC operating agreement and issue LLC units (certificates or shares) for their membership percentage of ownership

6. Know That Net Income of LLC’s is Still Taxed Even if Net Profits Are Not Withdrawn.  Be alert that the net income of flow-thru entities, such as LLC-partnerships, is still taxable to the owners, even if such income is not distributed to the owners in cash, Regulation 1.702-1(a). See next.

6A. Take Out Cash In A Tax Favored Manner. Distribute the net taxable income as cash to the members. At least they will have the cash to pay the
taxes. Even better create tax paper losses via the Goldmine componentizing deductions (beginning with Chapter 12), then pocket the property cash flow tax-free. Yes, you can still have positive cash flow yet with tax losses; see Chapter 1 for an example.

7. **Cash Basis of Tax Accounting** – Your LLC-Partnership should be on a cash basis of accounting where income is reported when received and expenses are deducted when paid. This is instead of an accrual basis where income is reported when earned, which can be *before* you receive the actual cash, which you do not want for real estate investment operations. Also the cash basis is simpler than accrual.

8. **Capital Contribution** - Your own cash you want to put into the LLC bank account can be done as a tax-free capital contribution (IRC 721) which you take out anytime as a tax-free return of capital.

9 **Deduct/Amortize organization costs for setting up an LLC.** Examples are legal fees, state filing fees and other such organizational fees. You can deduct, all in one year, up to $5,000 of such organization costs in the tax year the business begins. Expenditures over $5,000 must be amortized over 15 years.

   How and where deducted: Deduct as “legal fees”, either line 8 of IRS Form 8825 (supporting sch. to form 1065); or as “legal fees” on your own separate supporting schedule to line 20 (other deductions), page 1 of form 1065.

10. **Deducting education and travel expenses incurred by you before the LLC formation, not yet owning property.** To do this - have the LLC reimburse you the expenses under an accountable plan per Regulation 1.62-2(c). The LLC-partnership gets the deduction for the expenses, not you (directly), such as if you would have taken them on the very audit prone schedule C or E. You ultimately get the benefit of the deduction because the expenses will lower the LLC-partnership net income or increase its net loss, with either one (lower income or higher loss) flowing through to your 1040.
Alternatively, the LLC-partnership can purchase any educational materials from you where you previously had purchased them on your own. Again, the LLC-partnership gets the deduction for the expenses per the above. You would offset the sale by the cost of the materials so it becomes a wash to you, personally on your 1040. If the LLC does not have the cash to pay you, then take a promissory note (credit) from the LLC with the LLC still getting the deduction as per the above. Make sure the note is eventually paid off by the LLC to you; the sooner the better.

Reference Source (return tab): SAP 1, Part B

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
5-A

Use LLC’s, Not Corporations For Your Real Estate And Save Thousands

Reference Source (return tab): SAP 1, Part E

This chapter will cover the following about LLC’s, avoiding corporations...

A-1. LLC-PARTNERHIPS – SUMMARY OF SUPERB BENEFITS

A-2. POSSIBLE DRAWBACKS OF LLC’S WITH SOLUTIONS

B. REASONS NOT TO USE CORPORATIONS FOR REAL ESTATE OWNERSHIP, REASONS TO USE LLC-PARTNERHIPS

C. WHEN DO YOU USE CORPORATIONS – USE IN CONJUNCTION WITH LLC’S NOT IN PLACE OF LLC’S

A-1. LLC-PARTNERHIPS – SUMMARY OF SUPERB BENEFITS

LLC-partnerships have all of the legal benefits of a corporation; yet all of the excellent tax advantages of a general partnership; yet avoid the legal disadvantages of a general partnership and avoid the tax disadvantages of C-corps, S-corps and LP’s as follows:

On The Legal Side:

1. **Limited Liability for ALL Owners**: LLC’s have the corporate characteristic of limited liability for *all* of the owners (members). 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.

2. No Loss of Limited Liability By Participating in Management: Unlike a limited partner, any LLC member can exercise control over daily management decisions without the fear or actuality of losing their protected, limited liability status. Because LLC members can participate in management, they can bypass passive loss limits by “actively” or “materially” participating in property management.

3. LLC’s Do Not Have The Statutory Restrictions of S-corps: 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. An LLC can have more than one class of “membership interest” (similar to stock).

On The Tax Side:

1. Lower IRS Audit Risk. Two or more member LLC’s file a partnership tax return (1065), which is one of the lower audited IRS returns.

2. Much Less IRS Controversy. Partnerships do not have the controversial issues of “reasonable compensation” or ”constructive dividends” (as corporations do).

3. Avoid Being Dealer. An LLC-partnership, demonstrating investment intent with the consolidated entity approach, is a highly effective way of avoiding costly dealer status (See Chapter 6).
4. **No Salary Requirements and Payroll Filings.** Partnerships do not have to pay salaries to partners and thus avoid payroll filings. Optionally, guaranteed payments could be paid to create earned income for valuable retirement plan contributions.

5. **No Issues of “Reasonable Compensation”** that could lead to IRS scrutiny, full blown annoying audits and costly litigation.

6. **No Corporation Limits For Deducting Losses.** With LLC partnerships, tax losses are not locked in and pass through to the owners, without corporate limits.

7. **LLC Members Can Side Step Passive Loss Limitations.** Unlike limited partners, because LLC members can participate in management, they can bypass passive loss limits by “actively” or “materially” participating in property management (as covered in Goldmine Chapters 25 and 26 respectively).

8. **Tax-Free Cash Distributions.** Distribution of funds (including borrowed money) from an LLC-partnership will not result in current tax (single or double).

9. **Tax-Free Appreciated Property Distributions.** No gain is recognized to a member/partner upon the distribution of property, even if it is appreciated property (with built-in gains) where the value is higher than its adjusted basis.

10. **Tax-Free Appreciated Property Contributions.** Appreciated property can usually be contributed to the partnership, totally tax-free. If there is
taxability, planning is available. There are no tricky tax traps with basis issues as with S-corps.

11. Tax-Free Liquidations. A partnership can be fully liquidated at no income tax cost (single or double).

12. Tax-Free Conversions To LLC’s. General or limited partnerships can convert to LLC’s, free of income taxes. This is not so for corporations (C or S) with appreciated property.

13. Tax-Free Sales Via 1031 Tax-Free Exchanges. LLC-partnerships, splitting up, can much better accomplish a 1031 tax-free exchange to defer capital gains taxes.

14. Higher Tax Basis For Purchase of Partnership Interest. With the purchase of a partnership interest (including an LLC membership interest), the buyer-partner is entitled to a higher property tax basis by making a special election under IRC 754. This also includes a higher tax basis upon the death of a partner.

15. The flexibility of a Partnership by Allocating Income and Losses to the Members in a Manner That Best Suits The Members’ Tax Needs. For example, a member in a high tax bracket, may want allocated to them less of any net income or more of any net losses; or vice versa for a low bracketed member. These special allocations could be done in compliance with the partnership provisions of IRC 704 (b).

16. No Partner Loan Issues. With partnerships there are no issues of loans to partners as taxable dividends or salaries (as with corporations). In a nutshell, the intended benefits of LLC’s offer the best of several worlds:

A. The corporate shield of limited liability for all of the owners;
B. **Control** over management decisions for *all* of the owners; and

C. All of the **optimum tax advantages** of a general partnership.

**A-2. POSSIBLE DRAWBACKS OF LLC’S WITH SOLUTIONS**

All vehicles of asset protection and tax reduction have pitfalls and LLC’s are no exception. However, based on my research and opinions from experts, the following drawbacks are minimal when compared to corporations and essentially superficial.

1. **LEGAL** - Because LLC’s are relatively new, they have not yet been tested with actual legal disputes as corporations or limited partnerships. 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. Moreover, according to Wyoming state statute number 17-15-113, “Neither the members or owners of an LLC are liable under a judgment, decree, or order of a court, or any other manner for a debt, obligation, or liability of an LLC”. Many states follow this statute, which is a clear statement of limited liability.

   Moreover, LLC’s are not that new anymore. As of this writing they are over 30 years old in the United States and over 100 years old outside of the United States (with Germany as their birthplace in 1892). Furthermore, the 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, LLC’s give limited liability.

2. **LEGAL/TAX** - **State costs.** A number of states impose franchise fees on LLC’s as well as some annual taxes. However, corporations have the same
costs, and sometimes more so. But there is the legal and tax benefits you get from these entities.

3. TAX – LLC members side stepping passive loss limits for real estate professional status with less than 500 annual hours of material participation. The IRS has not officially clarified this issue. In their IRS Market Segment Specialization Program Guide on Passive Activity Losses, the IRS has taken the position that, like limited partners, all LLC members (even managers) must materially participate with 500 hours a year (or about 10 hours a week) to deduct an unlimited amount of rental property losses as an active real estate professional. Thus, where the LLC entity will generate tax losses, will the LLC member be subject to passive loss limits the way a limited partner is? If this were so, a member could not meet the lesser hourly tests for material participation (per Chapter 26) and therefore would be ineligible for real estate professional status allowing for the full deduction of rental losses without passive limits.

(a) No Official IRS Position - But this is still not an official position and IRS audit manuals do not have the force or effect of law. According to tax expert and national lecturer, Vern Hoven, CPA, MST, an argument can be made that the severe restrictions placed on limited partners by the passive loss rules was to prevent taxpayers from deducting losses from activities in which they were not involved with.

LLC members, who participate in the operation of an LLC, should be entitled to deduct losses, that they are responsible for! I agree.

(b) Strategy: If an LLC member is uncertain of this, then they should try to meet the yearly 500 hour test of material management participation in order to totally bypass passive loss limitations. To do so they should use the Goldmine forms, discussed in Chapter 26.
But the benefits of LLC’s far exceed any drawbacks, see part A-1 of this chapter.

**B. REASONS NOT TO USE CORPORATIONS FOR REAL ESTATE OWNERSHIP, REASONS TO USE LLC-PARTNERSHIPS**

LLC-partnerships avoid the following corporate disadvantages by *default* (automatically); by *election*; or by *planning*. When referring to a partnership the term “partner” includes a member of an LLC or more specifically of an LLC-Partnership. Such reasons not to use corporations pertain to both rental keepers and resale flippers.

1. **IRS AUDITS**: Corporations (C and S) are audited more than partnerships and corporate audits are on the rise. For instance, corporations are fairly frequent targets on the issue of reasonable compensation (discussed in number 4 below).

   **Partnerships** – By default, partnerships (IRS Form 1065) are one of the least audited entities. With partnerships there are virtually no IRS issues of reasonable compensation (no. 4 below).

2. **COSTLY DEALER STATUS**: Corporations are designed for active (ordinary income) businesses. Thus, using a corporation (C or S) for quick-sale flips is a blatant admission of costly dealer status and impairs dealer-avoidance planning.

   **Partnerships** – Consolidating flippers with keepers in one LLC-partnership is one the most effective ways to avoid dealer status. This type of entity structuring to totally avoid dealer status is discussed in Chapter 6.
3. PAYROLL FILINGS: Corporations (C or S) are subject to more payroll filings because corporate shareholders are employees and must receive a reasonable W-2 salary. In the case where there are annual tax losses in the corporation, a W-2 salary could cause unnecessary taxable income to shareholder-employees. How costly!

**Partnerships** –By default, partnerships (unlike C or S corporations) are *pure* flow-through entities where partners do not have to be paid a W-2 salary. In fact, a partner cannot be an employee for federal income taxes, Reg. 1.707-1(c). The partnership can just pay the partners straight distributions (like draws) without salary withholding or payroll filings. Such distributions are tax neutral in that that they are not deductible by the partnership and are tax-free to the partner, IRC 731.

<table>
<thead>
<tr>
<th><strong>Optional Guaranteed Payments</strong></th>
<th>- If a partner needs earned income for the basis of making valuable retirement plan contributions, the partners could receive such earned income without W-2 salaries. Here the partnership could pay a deductible “guaranteed payment” which is earned income 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. Thus, payroll reports do not have to be prepared and filed. However, to the partner, a guaranteed payment is subject to income taxes and Social Security taxes. But again, the guaranteed payment is earned income and the basis for making valuable retirement plan contributions. IRC 707(c). Guaranteed payments are optional and not required as with corporate salaries. What a winner! (If the partnership wants to take advantage of C-corp fringe benefit deductions, then make the C-corp a minority partner as discussed in Section 5-B)</th>
</tr>
</thead>
</table>

8
4. IRS SCRUTINY OVER “REASONABLE COMPENSATION” TO “C” OR “S” CORPORATION SHAREHOLDER-EMPLOYEES.

Reasonable compensation essentially means that the combined amount of wages and fringe benefits cannot be disproportionate in relation to the value of the work being performed. Whether compensation is considered reasonable will depend on a number of factors such as: duties performed, job responsibility, the nature and complexity of the business, etc.

It’s a controversial area with the IRS. Any part of the total compensation that is not considered by IRS to be reasonable could be recharacterized in an unfavorable manner resulting in additional tax liabilities. **For a C-corp, such IRS recharacterization would be less salary but more dividends resulting in potential double taxation.** [See *Mayson Manufacturing Co. v. Commissioner*, 49-2, USTC 9467, 6th Cir.; *Estate of Wallace*, 95 TC 37, 1990; *Westbrook*, TC Memo 1993-634, 66TCM, 1823; and other cases where the taxpayer lost on this issue].

For an S-corporation, such IRS recharacterization would be more salary resulting in more employment taxes. [See *Joly*, TC Memo 1998-361, 85AFTR 2d 2000-1234, 6th Cir; *Davis*, TC Memo 1997-80; *Eugene Ziobron Inc. v. U.S.*, 80 AFTR 2d 97; *Veterinary Surgical Consultants*, 117 TC No.14. *Yeagle Drywall*, 3rd Cir. and other cases where the taxpayer lost on this issue]. **As it can be seen, corporate reasonable compensation could be a hot issue with the IRS, but not with partnerships.**

**Partnerships** - By default, a partner cannot be an employee. Thus, partnership payments to partners are not subject to any issues of reasonable compensation and therefore not subject to any related IRS scrutiny (including expensive full-blown audits and litigation). This is so whether the
partnership payments are by way of straight Section 731 distributions or Section 707(c) guaranteed payments (discussed under no. 3 above).

5. LIMITS ON DEDUCTING LOSSES: One of the unique, magical virtues of real estate investments is that a property can be showing a “paper” tax loss, yet still be financially profitable with positive cash flow. This phenomenon is discussed in Chapter 1. Corporations (C or S) have limits on fully deducting rental property tax losses. With a C-corp, tax losses do not at all pass through to the individual, but are locked within the corporation as a totally separate tax entity. Thus, a C-corp will be a costly choice eliminating that magical combination of tax losses and positive cash flow.

EXAMPLE: Assume a property is held in a C-corp and it generates $20,000 of bottom-line tax losses. If the owner is in a 31% tax bracket, they would lose $6,200 of tax savings!

S-corps also have limits on claiming rental property tax losses. Tax losses (such as rental property losses) are limited to the shareholder’s basis in the S-corp’s stock, which does not include third party debt, such as a mortgage, IRC 1366(d); Maloof, TC Memo 2005-75; Frankel, 61 TC 343, 1973; Allen, 55 TCM 641, 1988 (and other cases). 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.

EXAMPLE: An investor forms an S-corp to acquire a rental property for a price of $200,000, with $10,000 down and a $190,000 mortgage. The investor contributes as capital the $10,000 down monies to the corporation, which becomes the investor’s stock basis. The corporation then acquires the property and obtains the $190,000 mortgage. The stock basis does not include the $190,000 mortgage, even if the investor is personally liable on
the note. Suppose, at the end of the tax year, the property shows a tax loss of $25,000. The investor can only deduct $10,000 as a tax loss, up to the stock basis of $10,000. The remaining $15,000 loss must be carried over until there is enough shareholder basis. Result: A loss of current tax savings, which could have been reinvested.

**Partnerships** – By default, partnerships bypass corporate loss limitations on losses. Again, partnerships are *pure* flow-through entities where losses could be passed through to the individual partner’s 1040, IRC 702(a). Partners can increase the basis in their partnership interest by mortgages and other types of partnership liabilities (recourse or non-recourse) to reflect increases in partnership liabilities and thus *increase their ability to deduct partnership losses*, IRC 752(a). As illustrated, an S-corp cannot do this (or could only do so perhaps with advanced planning; not necessary with a partnership).

6. **TAXABLE REFINANCING:** S-corporation distributions of tax-free borrowed money to shareholders could end up being taxable income because of the above basis limitations of not including third party debt. That is, the rule in number 5 above could make a tax-free refinance, taxable! Generally, when a property is refinanced with a cash takeout, the loan proceeds are tax-free. But with an S-corp’s distribution of the refinance proceeds to the shareholders this may not be so. The excess of this distribution over the corporate earnings & profits and the shareholder’s stock basis (which does not include the loan amount) is taxable gain, IRC 1368(b).

**Partnerships** – By default, partnerships distributions of borrowed money to partners are not taxable because partnerships are *pure* flow-through entities where such distributions are not taxable, IRC 731; IRC 701; IRC 702. Plus, the basis in a partnership interest is increased by mortgages and other types of partnership liabilities, IRC 752(a).
**TAX ALERT:*** Numbers 5 and 6 above demonstrate that S-corporations are not pure-flow-through entities and thus have restrictions especially with real estate ownership. With real estate, there is so much opportunity to accomplish transactions tax-free. This tax-free bonanza is best accomplished in a partnership *pure-flow through* entity, including an LLC-partnership. On the other hand, C or S corporations (lacking pure flow-through) impair the accomplishing of real estate transactions in a tax-saving manner.

7. **TAXATION OF DISTRIBUTED PROPERTY:** With corporations (C or S) there is taxation on distributions of appreciated property deeded from the corporation to the shareholder even though no cash is realized. With a C-corp, there is potential double taxation, first to the corporation in the amount of the gain (difference between property’s fair market value and basis), IRC 311(b). (Plus, C-corps do not have lower capital gain rates). And secondly to the shareholder as a “dividend in kind” in the amount of the property’s fair market value (limited by corporate earnings and profits), IRC 301. This could unnecessarily cost tens of thousands of dollars especially with high appreciated real estate values. Plus, such double income is phantom income as there no receipt of cash. With an S-corporation, there is no double taxation, but there is taxation (once is enough) to the corporation in the amount of the gain (difference between property’s fair market value and basis), IRC 311(b). Such gain would be passed from the S-corp to the individual shareholder’s 1040 as non-cash phantom taxable income.

**Partnerships** – By default, with partnerships as pure flow-through entities, such distributions of appreciated property from the partnership to the partners are tax-free, no matter how great the appreciation is. IRC 731.

8. **TAXATION ON ENTIRE CORPORATE LIQUIDATION:** With C or S corporations there is taxation on the liquidation of the entire corporate
entity (with appreciated real estate) even though cash may not be realized. Upon the corporate transfer of liquidated appreciated assets to the shareholders (including real estate) there will be the same dreaded tax consequences as in number 7 above. With real estate, you need tax-free exit strategies. You will not get this with C or S corporations.

**Partnerships** – By default, with partnerships as pure flow-through entities, such transfers of liquidated appreciated property from the partnership to the partners are tax-free, IRC 731.

**9. TAXATION ON CORPORATE CONVERSION TO AN LLC:** With C or S corporations, conversion of the corporation (with appreciated assets) to an LLC will result in tax liabilities even though cash may not be realized. There will again be the same costly tax consequences as in number 7 above. Thus, the tax cost of liquidating any corporation with appreciated assets is often so high that conversion to an LLC is often not a viable choice. You therefore need to plan your tax-free exit strategy in *advance* by *not* putting real estate in corporations in the first place.

**Partnerships** – By default, an existing partnership (general or limited), with appreciated assets (such as real estate), *can* convert to an LLC, income tax-free [RR 84-52, RR 95-37, IRC 721, PLR 9623016)]. The resulting LLC does not even have to obtain a new federal ID number.

**ALERT:** The above pertains to income taxes. There may be local transfer taxes on such conversions or transfers to LLC’s. For a further discussion, see Chapter 4, Strategy 6.

**10, 11 & 12 - TAXATION ON PROPERTY TRANSFERS TO A CORPORATION**
10. Transfers of appreciated property to a corporation (C or S) is taxable if the contributing shareholder is not in control of the corporation immediately after the transfer, IRC 351(a); Regulation 1.351-1(a). This could be a tax dilemma where there will be a more than 80% change in owners after the incorporation.

**Partnerships** – By default, with partnerships, there will never be taxable gain on the transfer of debt-free* appreciated property to the partnership even if the contributing partner is not in “control” of the partnership immediately after the partnership formation, IRC 721. (*Where there is debt on the property, see number 11, next.)

11. Transfers to a corporation (C or S) of property whose debt* exceeds the property’s adjusted tax basis do not increase the basis of the shareholder’s stock, IRC 358(a) and the shareholder ends up with a zero stock basis. (*High debt exceeding a property’s basis often stems from recent cash-out refinancing). For an S-corp, a low stock basis (including a zero basis) means more limits on deducting S-corp losses; and for C or S corporations, a larger gain on the sale or disposition of the corporate stock. Plus in this scenario where property is transferred to the corporation and the debt exceeds the property’s adjusted tax basis, there is taxable gain to the shareholder transferring the property, with no planning opportunity to avoid such taxable phantom gain.

**Partnerships** – By default, with partnerships (including LLC’s), the partner receives an increase in the basis of their partnership interest by including their allocable portion of debt, including the debt assumed by the partnership entity when it received the contributed property, IRC 752(a). Again, no such benefit is available for corporate shareholders. Also, with partnerships (including LLC’s), where property is transferred to the partnership and the debt exceeds the property’s adjusted tax basis, there could be taxable gain to
the partner transferring the property. But there are planning opportunities (not discussed here) for the partner to avoid or reduce such taxable gain, IRC 752. No such planning is available for corporate shareholders.

12. With C or S corporations, involving the transfer of property with debt to the corporation, if the transfer of the debt lacks a *business purpose* or has a *tax avoidance* motive, *all* such debt will be treated as phantom taxable gain to the shareholder transferring the property. This is so whether the debt exceeds the property basis or not, IRC 357(b). What constitutes lacking in business purpose or a tax avoidance motive is complex and not discussed here. The point to be made is that this provision could result in costly phantom income and is totally unnecessary by using partnerships.

**Partnerships** – By default, with partnerships (including LLC’s), no such provision (or I should say “tax trap”) exists, IRC 752. **NOTE**: Numbers 10, 11 and 12 involve some complex provisions. Therefore, even if you do not fully understand what is being said here, the bottom-line is this – these are nasty costly traps for real estate ownership in corporations, but not with partnerships, including LLC’s taxed as partnerships, or limited partnerships.

13. **INABILITY OR DIFFICULTY IN ACCOMPLISHING A 1031 EXCHANGE IN THE EVENT OF A SHAREHOLDER SPLIT-UP:** A stock interest in a corporation (C or S) does not qualify for a 1031 tax-free exchange, IRC 1031(a)(2)(B). (Although the corporation as an *entity* can do a 1031 exchange of real estate). If the corporation distributes property out of the corporation to the shareholders so they could go their separate ways, there will be tax liabilities as discussed in nos. 7 and 8 above.

**Partnerships** – A partnership as an *entity* can also qualify for a 1031 exchange. But in the event of a partner split-up, a partnership or LLC
interest (such as a 50% ownership) also does not qualify for a 1031 exchange, IRC 1031(a)(2)(D). However, unlike shareholder split-ups with corporations, tax-free planning could be done by converting the non-qualifying partnership interest into a tenant-in-common interest which does qualify for a 1031 exchange; or distributing the property out of the partnership to the partners as qualifying tenants-in-common, Rev. Rul 73-476. Such appreciated property distributions (with built-in gains) are tax-free from partnership to partners, IRC 731. (The same with LLC-partnerships). With the distributed property, the qualifying co-tenants can then do the 1031 rollover into separate replacement property, while other co-owners can opt not to do the 1031. Doing this with corporations would result in tax liabilities as previously discussed in nos. 7 and 8 above.

14. THE PURCHASER OF A STOCK INTEREST IN A “C” OR “S” CORPORATION CANNOT GET A STEP-UP IN BASIS FOR THE APPRECIATED REAL ESTATE WITHIN THE CORPORATION:
Instead of purchasing property directly from an entity, purchasing an ownership interest in the entity (such as corporate stock or a partnership interest) has several significant advantages -- no local transfers fees, no increased property tax assessments, it’s totally private. However, one buyer disadvantage is generally a lower tax basis in the property. For example, assume the property in the corporate entity is worth $2,000,000 and has a tax basis of $100,000. If the purchaser buys the property directly from the corporation for $2,000,000, then $2,000,000 will be their basis. But if they buy the corporate stock for $2,000,000 the purchaser’s basis in the property will be that of the corporation - $100,000. This means a big loss in tax savings because of much less depreciation deductions and/or a much larger gain upon the sale or disposition of the property. (Also, for an S-corporation, upon the death of a shareholder, there is no step-up in basis for the assets within the S-corporation, including any real estate.)
Partnerships – By election, with the purchase of a partnership interest (including an LLC membership interest), the buyer is entitled to the higher $2,000,000 basis by making a special partnership election under IRC 754. This means the preservation of the tax savings and the above mentioned non-tax benefits of purchasing an interest in a partnership or LLC. (This also pertains to the death of a partner, unlike an S-corp). [For an in-depth discussion of this powerful strategy refer to my commercial tax course – Astronomical Tax Savings With Commercial Property].

15. NO SPECIAL INCOME\LOSS ALLOCATIONS: With C or S corporations, income or losses must be apportioned strictly in accordance with the exact percentage of shares owned, with no variations of special allocations to different shareholders.

Partnerships - Income, gains & losses can be allocated to partners in a proportion that differs from their partnership percentage ownership where partners in high brackets can be allocated more losses or less income, and vice versa for partners in low brackets. Such special allocations must be done under the provisions of IRC 704(b), but they could be done only with a partnership, including an LLC-partnership.

16. IRS ISSUES WITH INSIDER LOANS: With C or S corporations, loans to shareholders and officers are ways to take out tax-free money out of corporations. But such “insider” loans could be subject to close IRS scrutiny including the following: The loan must be evidenced in writing with arm’s length loan documents, interest charged, a payment schedule, payments actually made, security for the loan, corporate resources to make the loan, individual capacity to repay the loan, conduct of the parties, etc. Otherwise, the IRS may recharacterize the loans as a taxable dividend or taxable salary.
Such IRS recharacterization could be avoided with the proper documents and formalities. But all of this is not necessary with a partnership.

**Partnerships** – By default, with partnerships there really are no such issues because there are no dividends with a partnership, and partners are not required to be paid salaries, IRC 731. Partnerships distributions of borrowed money are not taxable because partnerships are *pure* flow-through entitles, IRC 701; IRC 702; IRC 731.

**17. OTHER DRAWBACKS OF S-CORPORATIONS:**

1. **Freeze on unused losses** - Termination of an S-corp status freezes the deductibility of unused carryover losses.

2. **Limits as to shareholders** - S-corporations cannot have as shareholders – IRA’s, corporations, partnerships and non-resident aliens. Otherwise it will lose S status to a C-corporation.

3. **One class of stock** - An S-corp can have only one class of stock ownership.

4. **Debt/equity may cause loss of S status** - Because of the above, shareholder debt that resembles equity too closely could be treated as a second class of stock causing loss of S-corp status to a C-corporation.

5. **Passive income causing loss of S status** - If a profitable S-corp has passive income that exceeds 25% of gross income for three consecutive years, there will be loss of S-corporation status to a C-corp.

6. **Need to file election** - There is the need to properly and timely make the “S” election and continually comply with the various federal and state requirements to preserve “S” status. (Loss of S status to C status could be a tax disaster in itself).
Partnerships – By default, partnerships (including LLC-partnerships) have none of the above drawbacks. Plus few a states tax S-corps but not LLC’s.

18. OTHER DRAWBACKS OF C-CORPORATIONS:

1. **No capital gain** - No lower capital gain rates, taxed at higher ordinary corporate rates.

2. **Recapture** - Depreciation recapture from straight-line depreciation taxed at higher rates.

3. **Penalty taxes** - Numerous penalty taxes (such as accumulated earnings tax).

Partnerships – By default, partnerships (including LLC-partnerships) have none of the above drawbacks. Moreover, almost all states tax C-corporations more than LLC’s.

The above includes almost 30 reasons why not to use corporations as a primary entity for real estate ownership and instead use LLC-partnerships for both rental keepers and resale flippers. If this “corporate tax indigestion” does not convince you, I don’t know what will!

**C. WHEN DO YOU USE CORPORATIONS – USE IN CONJUNCTION WITH LLC’S NOT IN PLACE OF LLC’S**

1. **Designed for businesses not involving real estate** - Corporations (C or S) are designed for businesses not involving the ownership of real estate. The primary tax benefits of C-corps are certain fringe benefit deductions and
the use of a fiscal year. For S-corporations the “S” stands for small business and that’s what S-corporations are for small businesses, not real estate. The primary benefit of S-corporations is the reduction of employment taxes (including Social Security) for profitable businesses, not involving real estate.

[For how an S-corp reduces employment taxes refer to my course, *The Ultimate Tax Bible for Self-Employed Entrepreneurs (the “Bible”), CD 7*]

2. **Only use C-corps as a minority (low percentage) LLC Member** - If an investor wants to take advantage of the benefits of corporations for their real estate investments, then they should use the corporation in a secondary position as opposed to a primary entity. For example, if an investor wanted to benefit from certain C-corporation deductions, instead of making the C-corporation the primary entity owner of the real estate or a management company, make the C-corp a minority member of a real estate LLC, with a low ownership percentage. This is discussed in the next chapter, 5-B.

3. **Only consider S-corps as GP in an LP** - An S-corporation could also be a low-ownership-percentage general partner in an LP used for dealer property. This is discussed in Chapter 7-A.

**IN SUMMARY:** For real estate, you use corporations for their benefits *in conjunction* with LLC’s (or LP’s), and *not* in place of LLC’s (or LP’s).

Reference Source (return tab): **SAP 1, Part E**

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**
Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
5-B

How Real Estate Investors Can Take Advantage Of C-Corp Deductions Yet Without C-Corp Tax Disadvantages

Reference Source (return tab): SAP 1, Part C

This chapter will cover the following...

A. SPECIAL C-CORPORATION DEDUCTIONS
B. DO NOT MAKE THE C-CORP A MANAGEMENT COMPANY
C. USE THE C-CORP AS A MINORITY (LOW PERCENTAGE) LLC MEMBER
D. ANOTHER GREAT DEDUCTION FOR C-CORPORATIONS - RENTING YOUR HOME TAX-FREE FOR 14 DAYS
E. CONSIDER USING A C-CORP EVEN WITH A SPOUSE TO HIRE BECAUSE OF RENT-FREE DEDUCTIONS AND FISCAL YEAR
F. REMINDER: DO NOT USE A C-CORP AS A PRIMARY ENTITY FOR REAL ESTATE

A. SPECIAL C-CORPORATION DEDUCTIONS

1. C-Corp fringe benefit deductions - C-corps have several deductions that other forms of ownership generally* do not have which are mainly employee health-related fringe benefits such as disability plans, health insurance plans, medical reimbursement plans, group life insurance, plus tax-free home rental arrangements (discussed in part D).
2. **Non-C-corporate spousal medical fringes** - *However other forms of ownership could essentially have almost the same deductions for such health-related fringe benefits, by the entrepreneur hiring their spouse as an employee and paying them compensation including deductible reimbursement for these types of fringe benefits. That is, with a Section 105(b) spousal medical reimbursement plan, a sole proprietor (Schedule C or E, including a single member LLC) or a non-husband & wife partnership (form 1065), with a spouse-employee, can essentially have the same health-related fringe benefits. S-corporations are more limited. [For more about this refer to my audio CD series, *Power-House Tax Strategies For Self-Employed Entrepreneurs* (the “Bible”) or *Medical Reimbursement Plan Kit*].*

3. **No spouse to hire use a C-corp** – But if there is no spouse to hire; or it is not feasible or desirable to get a spouse involved, you then will need a C-corp to take full advantage of these health related fringe benefits. See next.

**B. DO NOT MAKE THE C-CORP A MANAGEMENT COMPANY**

1. **Background** - Before discussing the reasons for the above, some background first. Some investors prefer to use another separate corporate entity to manage the properties. Let’s look at the legal and tax side.

   (1) **Legal Side - Collapsible:** The legal reason for this is that the separate entity will act as your rental property management company as a decoy in dealing with tenants, contractors, vendors, etc. In the event of a legal dispute or action from one of these (tenants, contractors, vendors, etc.), the management company (acting as a decoy) is a separate and distinct entity apart from you. Presumably, any legal action will be brought against this managing corporation and not against you, or not against whatever entity owns the property (such as an LLC-partnership). This management corporation will have little assets to attach in the event of the legal action.
This is why it may give you additional asset protection. But, on the legal side, for this asset protection strategy to work effectively, the management corporation must do all of the managing. If you, in your capacity as an individual or as an LLC member, do any management at all, then claimants could bring a legal action against you or your real estate LLC, instead of the management corporation. A smart attorney may be able to prove that you or your real estate LLC did at least some management and therefore is liable to the claimant (tenant, contractor, vendor, etc.), or is somehow responsible. And therefore not even bother suing the decoy (limited asset) management corporation. So, legally, this asset protection device could be flawed.

(2) Tax Side – Passive Loss Limits: Here too is a potential pitiful of the IRS disallowance of rental property tax losses. If this separate rental management entity does too much management (when legally it’s suppose to do all managing), then you may be too passive and thus may not be able to currently deduct rental property losses because of the passive activity loss (PAL) limitations of IRC 469. Reason: In order to bypass PAL limits and deduct losses you or your spouse must perform a certain amount of management functions, especially landlord-tenant activities. These functions must be performed by you or your spouse (individually or as a managing member of an LLC that owns the properties), not another entity, even if it’s your entity. Understand that the management company (LLC or corporation) is a separate, distinct entity apart from you and your spouse. Thus the management company’s performance of these activities is not attributable to you. In one case, a real estate owner was denied current property deductions because his management corporation (a separate entity) materially participated in the management of the properties, instead of the partnership that owned the rental properties. David H. Hillman, 4th Circuit, 4/17/01. In another case a real estate investor was totally subject to the PAL limitations because the management company handled all of the
affairs of the investor’s real estate. They consequently were not even entitled to the $25,000 loss allowance, let alone unlimited loss deductions with real estate professional status under IRC 469(c)(7). *Madler vs. Commissioner*, TC Memo 112, 1998. Moreover, top tax experts throughout the country agree with these conclusions of the courts based on IRC 469. *(NOTE: These PAL limitations pertain to using your own management company or an outside one. See ch. 26 for documenting the required management hours)*

2. **Don’t need C-corp as management company** - When using the C-corp to take full advantage of these health related fringe benefits. do not make a C-corp your management company for this purpose (or any other purpose). You do not need your own management corporation, along with its legal and tax disadvantages because there is an excellent cost-effective solution where you can protect multiple property equities in one entity from being attached. Refer to our special report, *Equity Stripping Excel - How To Use Only Two LLC’s To Protect Any Number Of Properties In Any Number Of States*. As far as generating C-corp deductions, see next.

**C. USE THE C-CORP AS A MINORITY (LOW PERCENTAGE) LLC MEMBER**

1. **An LLC Minority (Low Percentage) Member** - Therefore, instead of making the C-corp a management company and getting hit with PAL limitations and the loss of tax savings along with the other tax disadvantages of C-corps, make the C-corp a 1% to 5% minority member in your real estate LLC-partnership. That is, you place the corporation in a secondary position as opposed to a primary entity and still receive C-corp deductions. Read on how to do it.
2. Example – A real estate LLC-partnership reaping C-corp deductions by using a C-corp as a minority member-partner:

(a) LLC arrangement with C-corp member - You form a C-corporation which will be a 2% non-voting member in your real estate LLC-partnership. The shareholder-owner of the C-corp could be you and/or your spouse or others. (Note: If you were a sole owner of your real estate and needed a partner to have the very favorable tax benefits of a partnership, then another advantage of the C-corp is that it is the other partner to create the real estate LLC-partnership). The C-corp member will provide real estate investment strategy advice for the LLC-partnership. The C-corp will be a minority member with only 2% voting management rights and no say in the daily operations of the real estate LLC-partnership. The other individual non C-corp members, as “Managing Members” will materially participate in property management and daily operations. This will be for the purposes of bypassing PAL limitations (and saving taxes) as previously discussed. The above arrangement with the C-corp minority member shall be incorporated in the LLC operating agreement.

(b) LLC guaranteed payment to C-corp member - The LLC-partnership will pay the C-corp a Section 707(c) guaranteed payment for the investment counseling services of the C-corp. The amount of the guaranteed payment should approximate (not exactly equal) what the C-corp will pay for the health & medical fringe benefits along with at least some W-2 salary to the shareholder(s)-employee(s) as part of total reasonable compensation (salary plus fringe benefits).

(c) Deducting your medial costs as fringe benefits - Assume you and your family have out-of-pocket health insurance and expenses of $20,000 annually and you are in a total tax bracket of 30% (rounded). So your annual tax savings will be $6,000 (30% x $20000) or more than enough to
justify the set up and maintaining of the C-corp. The LLC-partnership will pay a quarterly guaranteed payment of $7,500 (or annual amount of $30,000) to the C-corp for the investment counseling services as provided for in the LLC operating agreement. The C-corp (as a separate entity) will pay the shareholder(s)-employee(s) annual total compensation of $22,000 which will consist of a $2,000 W-2 salary and $20,000 employee benefit reimbursement of your family’s annual out-of-pocket health insurance and expenses. The $2,000 salary will be paid in the fourth quarter of the year to reduce payroll filings. The C-corp will also be authorized by the LLC operating agreement to pay for real estate seminars and related travel up to $6,000. Based on this, at the end of the year the C-corp will show a small amount of taxable income of $2,000 which is $30,000 annual guaranteed payment less total compensation of $22,000 and seminars of $6,000 (total $28,000). The $2,000 of C-corp taxable income could be offset by LLC-partnership rental property losses allocated to them as a 2% member.

(d) **The bottom-line savings** - The deduction (and tax savings) stems from the LLC-partnership’s paying the guaranteed payment to the C-corp. [(A guaranteed payment is deductible by the partnership, IRC 162(a); IRC 707(c)]. This deductible guaranteed payment decreases the LLC’s net taxable income, or increases the LLC’s net tax losses. Such decreased income, or increased loss, flows through to your 1040 via the LLC-partnership K-1 and thus creates the tax savings on your individual 1040.

**D. ANOTHER GREAT DEDUCTION FOR C-CORPORATIONS - RENTING YOUR HOME TAX-FREE FOR 14 DAYS**

1. **Tax-free rent deduction for 14 days** - The C-corp could also rent your home from you annually for 14 days or less. Your corporation gets the deduction and you pay NO taxes at all. **Reason:** Rent income received for an
annual period of 14 days or less is not taxable, IRC 280A(g). Under the home-office limitations for corporations [IRC 280A(c)(6)], you may not claim any related expenses of your home, but here the rent income is totally tax-free; yet deductible by the corporation, IRC 162. (Double taxation the right way, your way!) The corporation could rent the home for 14 days a year for documented corporate member meetings business functions, office use, webinars, etc. This could turn out to be a big tax-free deduction. Assuming you have a nice home (which I am sure you do), if you had to rent a nice hotel for corporate meetings and lodging at the least it would cost $250 a day times 14 days = $3,500 again fully deductible by your corporation and tax-free to you. If you could justify $500 a day the deduction would be $7,000 ($500 x 14 days). Some of my students justify as high as $2,000 per month or $28,000 annually where their home is also a recording studio for real estate education.

2. Increase guaranteed payment - Again, the way the LLC-partnership would get this deduction is to increase the guaranteed payment to the C-corp by a similar amount as per the previous example.

3. Fair market rental - The rent must be at fair market value along with an arms-length lease. Obtain from a qualified real estate professional or a hotel management company a written opinion as to the fair rental value of the property for this purpose. Rent the home to the C-corp for that amount.

4. Alert on IRS recharacterization\hedge agreement - With a C-corp, the IRS may try to recharacterize the “unreasonable” portion of the rent as a non-deductible dividend payment (with possible double taxation, the wrong way). What you should do is have a “hedge” agreement which should allow the C-corp double taxes to be avoided. What is required is that you, the shareholder-employee, agree to pay back to the corporation any rent payments disallowed by the IRS. The corporation loses the deduction,
but you personally deduct the repayment. So it’s a wash where the hedge effectively brings everything back to where they were before.

**E. CONSIDER USING A C-CORP EVEN WITH A SPOUSE TO HIRE BECAUSE OF RENT-FREE DEDUCTIONS AND FISCAL YEAR**

1. **C-corp advantage with tax-free rent deductions** - Even with a spouse to hire for a spousal health benefit plan (discussed at the beginning of this section), you still may want to instead use the C-corp because of the above powerful rent-free deductions.

2. **C-corp partner for entity protection** - Plus the C-corp could be that needed partner to file as a partnership tax entity for the LLC. Having the C-corp as an LLC member augments asset protection via another state-registered entity as a corporate member enhancing the LLC-partnership as an *entity*, separate and distinct from its member-owners with the shield of limited liability. This also enhances charging order protection (see ch. 7A).

3. **C-corp fiscal year** – Another tax advantage of a C-corp over other entities is the use of a fiscal year end instead of December 31. Using a fiscal year end can allow for the deferral of income and the use of deferred tax savings.
4. **Set up the legal formation of another LLC and elect the LLC to be taxed as a C-corp.** So the minority member would be another LLC taxed as a C-corporation. *Reason:* The legal formation of an LLC is simpler than that of a C-corp and generally gives better asset protection (charging order protection). Yet you still have the tax favored C-corp deductions, per the above.

**F. REMINDER: DO NOT USE A C-CORP AS A PRIMARY ENTITY FOR REAL ESTATE**

The same for an S-corp. This is for any type of property – keepers and flippers per Chapter 6 and because of the many corporate tax advantages for real estate per Chapter 5-A. Only a C-corp as secondary entity as per this chapter.

Reference Source (return tab): SAP 1, Part C

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you
are committing a serious copyright infringement crime, punishable by severe fines and
imprisonment, and you may be held liable under BOTH civil and criminal law.
Use The One Real Estate LLC For Both Keepers and Flippers (Wholesaling and Rehabs) To Avoid Costly Dealer Status – No Separate Entity For Non-Dealer Flips

Reference Source (return tab): SAP 1, Part D

This chapter will cover the following...

A. SOME IMPORTANT POINTS ABOUT THE DEALER ISSUE

B. TAX SIDE -- SEPARATE ENTITY VS CONSOLIDATED ENTITY

C. LEGAL SIDE -- YOU CAN LEGALLY PROTECT MULTIPLE PROPERTY EQUITIES IN ONE CONSOLIDATED ENTITY WITH EQUITY STRIPPING AND/OR A LAND TRUST

A. SOME IMPORTANT POINTS ABOUT THE DEALER ISSUE

1. Flipping does not necessarily make you a dealer - Just because you start to flip properties, does not necessarily make you a dealer. Keeney (1929) 17 BTA 560 (A); Gibson, TC Memo 1981-240. Quickly selling properties and dealer status are not synonymous.

2. Review investor\dealer issue - You may first want to review the issue of investor vs. dealer (including more planning strategies) by referring to Chapters 41, 42 and Appendix E (PAPPE). You especially want to review investment intent and the Supreme Court Case, William Malat and its predecessor case, Municipal Bond Corp.
3. Investors get many tax benefits, not dealers - As per Chapter 41, as an “investor”, you are entitled to many tax benefits that “dealers” are not entitled to. Again, you may want to first review Chapter 41.

B. TAX SIDE -- SEPARATE ENTITY VS CONSOLIDATED ENTITY

1. Using separate entities for keepers and resale property is **not** the way to avoid being a dealer - With the issue of investor vs. dealer, a conventional recommendation is to clearly separate the “dealer” property from the “investor” property by using separate entities. A separate entity for rental keepers and a separate entity for the resale flippers. But this recommendation is based on the position that all flippers (including beginners or part-time) are dealer property (which is not true). As legendary football coach Joe Paterno says, “You play to win!” That is, you want to avoid being a dealer altogether. This includes using a separate “dealer” entity which is not a way to avoid being a dealer.

2. Using a separate entity for resale property causes you to be a dealer - The most common way investors get tagged with the money-draining consequences of being a dealer is **not** from the IRS; but from the investors, themselves, taking the overt position they are a dealer (often from the inaccurate advice of their CPA’s*). One almost certain admission of dealer status is using a separate entity for resale flippers. It’s like waiving a big sign, “Hey IRS, look at me; I’m a dealer; tax me to death!” Why? If the flippers are by themselves in a separate legal entity (not with rental keepers) then the IRS is in a strong position to assert dealer status because the flippers (by themselves solely as resale flippers) are held primarily for sale to customers and selling is of **first importance**, *William Malat v. Riddell*, 383 US 569, 1966. That is, the sales purpose is **dominant** (dealer intent as
opposed to investment intent), *Municipal Bond Corp*, 341 F2d 683, 1965. (Underlined emphasis added for dealer sales intent).

*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.”*

3. Avoid being a dealer with **Investment Intent** - One of the best ways to avoid being a dealer is to demonstrate *investment intent* by consolidating your resale flippers with your rental keepers in the same *investment* entity – an LLC-partnership (discussed in Chapter 5). Based on numerous tax courts cases (including the Supreme Court Case, *William Malat*), actual IRS audits, the author’s extensive research and experience; with planning even a very large number of quick sales in one year could avoid costly dealer status. Instead, you use an LLC-partnership which is a less audited entity than a corporation. Again, this LLC-partnership entity is for both your flippers and your keepers (wholesaling and rehabs).

**Why do it this way?** With this “investor” position, we 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*. That is, the sales intent of the flippers is buried by the investment intent of the keepers. This is the opposite of the separate entity approach where the selling (dealer) intent is dominated and such dealer intent could absorb the keeper (investor) intent.
We don’t want this. By consolidating the keepers with the flippers we are putting substance behind the *Statement Of Investment Intent* from Appendix E or the Forms Appendix in the SAP’s which statement states that we intend to keep all properties, unless there are liquidating circumstances where we must sell. This rental/investment intent (via the *Statement Of Investment Intent*) is supported by actually having rental keepers in the *same* entity with the flippers. This cannot happen with a separate entity for rental keepers and another separate entity for resale flippers.

4. **Positive bottom-line result = save thousands** - You avoid dealer status and save thousands every year by using the one consolidated LLC-partnership* for both keepers and flippers. By not being a dealer you could avoid taxes on resale profits via a *1031 Exchange, Seller Financing Installment Sale, Self-Directed IRA* and other ways per Chapter 31.

5. **An alternate entity may be an LP** - Where there will be substantial state taxes and the state taxes LLC’s, but not limited partnerships, consider a limited partnership (LP), instead of the LLC. But before doing so, review Chapter 7 on the limited use of LP’s.
C. LEGAL SIDE -- YOU CAN LEGALLY PROTECT MULTIPLE PROPERTY EQUITIES IN ONE CONSOLIDATED ENTITY WITH EQUITY STRIPPING AND/OR A LAND TRUST

1. Potential asset protection drawback - Using the above consolidated entity strategy to avoid costly dealer status, causes the equity of your keepers and flippers to be all in one entity. Without planning this could be an asset protection drawback.

2. Solution is equity stripping - This is an excellent cost-effective solution where you can protect multiple property equities in one entity from being attached and still do the above dealer avoidance consolidated entity strategy. It’s called equity stripping – stripping out the real estate LLC’s equity and replacing the equity with debt of another company you control, not reachable by claimants.

Special Report - Refer to our special introductory report, (also on audio CD) - Equity Stripping Excel - How To Use Only Two LLC’s To Protect Any Number Of Properties In Any Number Of States. To get the report go to the Goldmine Member Only Web Site – www.goldminevipaccess.com. With your R-GM VIP code mail us for the access password.

3. Land trust – Alternatively or in addition to equity stripping, you can transfer each property (in the same LLC) to a land trust with the LLC as the beneficiary of each land trust. For experts on land trusts, email us with your Renaissance VIP code.

Reference Source (return tab): SAP 1, Part D
Limited Partnerships – Their Limited Use For Real Estate Ownership

A. LIMITED PARTNERSHIPS – LEGAL & TAX STATUS

1. Legal Status: 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 can be both a general and limited partner.) The general partner is given control of the business and is personally liable for all partnership debts & obligations. A way to insulate the general partner from personal liability is for them to become a corporation or an LLC.
An LP, with a corporate or LLC general partner, insulates the entire LP from personal liability.

2. **Tax Status:** An LP is a pass-through entity and is generally taxed like a general partnership, filing the same tax forms and has almost all of the same tax advantages discussed in Chapter 5, but except for passive loss limits discussed in Part B of this chapter. Internal Revenue Code Sections 469(i)(6)(c) and 469(h)(2).

### B. LEGAL AND TAX DISADVANTAGES OF LP’S

1. **LP legal side disadvantage – More complex:** Legally LP’s are more complex than LLC’s because for total limited liability it must have two entities. 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 a corporation or an LLC. Thus you have two entities: (a) The limited partnership itself and (b) The corporation, or LLC, as the general partner. This entails more set up costs and more annual costs. An LLC needs only to be the one LLC entity. All LLC members have limited liability even though they can manage. They have the limited liability of a limited partner, yet they could have the management control of a general partner, but protected.

2. **LP tax side disadvantage – PAL limitations** Unlike managing 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. IRC 469(c). They cannot come under the $25,000 loss exception (per Chapter 25), or the unlimited deduction of
rental property losses for active real estate professionals, who materially participate in the property’s management (per Chapter 26). Internal Revenue Code Sections 469(i)(6)(c) and 469(h)(2). *Reason:* By state statute a limited partner cannot at all participate in management. Accordingly, any 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. Internal Revenue Code Sections 469(i)(6)(c) and 469(h)(2).

**NOTE:** But limited partners can elect *not* be treated as a limited partner and bypass these passive loss limits by falling within any one of the following four exceptions: (1) If the limited partner is *also a general partner* at all times during the partnership’s tax year or, (2) By participating 500 or more hours per year, or (3) The limited partner participated for five of the last ten years, or (4) The limited partner participated for any three years in a personal service activity.

**LEGAL ALERT:** If the limited partner participates in the management of the business, then they will be subject to the same personal liability of a general partner and thus defeat the primary purpose of the LP > limited liability. In fact, the word “limited” must be used in the name of the partnership. Failure to do so will cause all partners (including limited partners) to be personally liable.

**C. WHEN TO USE LIMITED PARTNERSHIPS INSTEAD OF LLC’S**

**– HIGH STATE TAXES; DEALER PROPERTY**

There are two tax scenarios where you should use an LP, instead of an LLC:

1. **High state taxes** - Where there will be substantial state taxes and the state taxes LLC’s, but not LP’s;
2. Dealer property - regardless of state taxes.

These are further discussed.

1. Where there will be substantial state taxes and the state taxes LLC’s, but not LP’s.

(a) State franchise taxes - A few states have franchise taxes on LLC’s but not LP’s. Presently these states are becoming less & less. (Right now it looks like Pennsylvania and California, but this could change; so check with us).

(b) But state taxes often are based on a “net” amount - So before jumping into the more complex LP, understand that such state taxes are often based on net income or some “net” amount. Therefore if an entity is composed primarily of keeper rental properties, there will be deductions to reduce net income and even show a tax loss, with the frequent result of little or no state taxes. Permitted deductions are entitled to depreciation, repairs, component write-offs, mortgage interest, real estate taxes and a host of operating expenses. If you use the Goldmine componentizing system, you will have huge deductions. Typically these deductions exceed property income and create a paper loss as discussed in Chapter 1.

Moreover, you may have additional “overhead” deductions that are common to all of the properties such as office expenses, telephone, travel, entertainment, web site fees, salaries (including family members), fringe benefits (including family members), educational publications, tools, supplies, equipment rental, professional fees, association dues, boot camps, real estate seminars, etc. (See Chapter 23).

These too reduce net income or increase a net loss.

(c) Use LLC with low\no net amounts and low state rates - In this high deduction scenario, you should use the more advantageous LLC. Even with
some net positive taxable income (or even gross income) state rates are usually low and therefore usually not worth the additional cost and complexity of an LP.

(d) **Use LP with high state taxes** - In a state that does not tax LP’s (but does LLC’s), then an LP should be considered if the entity will be showing a significant amount of taxable income (and state taxes) from substantial operating cash flow even after tax deductions for depreciation, repairs, taxes and other operating expenses. Such positive taxable income can come from free & clear properties (no interest), out of depreciation, high rents, low expenses, buying bargains, buying cheaper lower-end housing or any combination thereof. But more often, substantial taxable income (and state taxes) comes from profits on the sale of properties. This is usually more the case.

**Reminder:** **LP’s are subject to passive loss limits.** Moreover if the properties are showing tax losses, you will not be able to deduct such losses against your other income because LP’s are totally subject to passive loss limitations, IRC 469(i)(6)(C); IRC 469(h)(2). LLC’s are not subject to these loss limitations for active members. **Not being able to deduct property tax losses can be much more costly than incurring state taxes** (such as a 5% state rate vs. a 30% income tax bracket).

2. **For dealer property (regardless of state taxes).** Based on the extensive research of this publication, my criteria of who a dealer really is very narrow. If your business is that of a full-time builder developer you are a dealer (barring any liquidating factors). If you are full time at flipping properties, do a very large number of flips annually, this is your primary business with the true intent to sell, then most likely you are a dealer. Less than these scenarios, you could plan to avoid being a dealer based on my extensive research of the applicable law and the pertinent strategies from the Goldmine. Otherwise, use LP’s for dealer property as discussed in Chapter 7-A.

Reference Source (return tab): **SAP 1, Part F**
Using An LP For Dealer Property

This chapter will cover the following...

A. THE NARROW CRITERIA OF WHO A DEALER REALLY IS
B. USING A LIMITED PARTNERSHIP (LP) VS A CORPORATION
C. WHICH ENTITY TO USE FOR THE LP GENERAL PARTNER
D. STRATEGIES WHEN USING A CORPORATION AS GP
E. HOW TO USE AN LP FOR DEALER-FLIPPERS
F. PROPER LP FORMATION AND FORMALITIES
G. IF LP SHOWS TAX LOSSES, LIMITED PARTNERS SUBJECT TO PASSIVE LOSS LIMITS ON INVESTOR-RENTAL LOSSES – DON’T USE
H. LLC’S WITH TWO CLASSES OF OWNERSHIP (MANAGING AND LIMITED) COULD BE USED AS A DEALER ENTITY INSTEAD OF AN LP
I. IMPORTANT REMINDER: INVESTOR VS. DEALER IS NOT A BLACK & WHITE ISSUE
J. LPS’ AVOIDING STATE TAXES
Based on *extensive* research, my criteria of who a dealer really is very narrow. If your business is that of a full-time builder-developer you are a dealer (barring any liquidating factors). If you are full time at flipping properties, do a very large number of flips annually, this is your primary business with the true intent to sell, then most likely you are a dealer. Less than these scenarios, you could plan to avoid being a dealer based on strategies from the Goldmine. Otherwise, read on.

**B. USING A LIMITED PARTNERSHIP (LP) VS A CORPORATION**

For dealer property, LP’s are superior to S or C-corporations for the following reasons:

1. **Less employment taxes without having to pay salaries to limited partners.** *Reason:* As active business income, dealer profits are subject to Social Security and other employment taxes, IRC 1402(a). But the share of income of limited partners (including dealer profits) is not subject to Social Security taxes, Prop. Reg. 1.1402(a)-2(g); IRS Pub. 533. S-corps can also save on Social Security taxes. However, as S-corporation employees, shareholders must receive a portion of income as a salary (which is subject to Social Security taxes). Thus, while an S-corp can save on Social Security taxes, it is subject to more payroll filings. With an LP, to take advantage of this benefit, salaries do not have to be paid to limited partners because partnerships are pure pass-through entities for the owners. The share of profits or compensation to the general partner (GP) for their active participation is subject to Social Security taxes, but compared to total partnership income, this should be a smaller amount subject to such taxes. Plus, you could make the general partner an S-corp to reduce Social Security taxes for the GP owning a low percentage of the LP, as discussed later in this chapter, C-2.
2. Less IRS scrutiny over reasonable salaries. In addition, unlike an LP, an S-corporation is subject to more IRS scrutiny and controversy over the issue of paying “reasonable compensation” to shareholders. The IRS wants to see more salary compensation in order to collect more in the way of Social Security taxes and other employment taxes. Accordingly, S-corps have become more frequent targets for audits. C-corps too are subject to issues of “reasonable compensation”. On the other hand, with an LP, because W-2 salaries do not have to be paid, there are no issues of reasonable compensation to partners. The issue does not exist just by the very format of the partnership 1065 versus the S-corp 1120S or C-corp 1120.

Note: The GP may be a C or S corporation with these corporate issues. But a corporate GP will only own a very small percentage of the LP entity, so there should be less of such issues. Plus you could apply audit-proofing planning strategies discussed in part C of this section.

3. Even without W-2 salaries, an LP can still pay compensation eligible as earned income and the basis for making valuable retirement plan contributions – a guaranteed payment. Such earned income is created by the partnership paying the partner(s) something called a “guaranteed payment” which is a payment that is made without regard to partnership income. Such payment is ordinary earned income to the recipient-partner, IRC 707(c); IRC 61(a); but the payment is deductible by the partnership, IRC 162(a); IRC 707(c). The guaranteed payment is for specific services rendered by the partner to the partnership in their capacity of a partner. Examples of such services could be maintenance, contract work, accounting, bookkeeping, marketing, consulting, etc. The guaranteed payment arrangement should be incorporated in the partnership agreement. The guaranteed payment is not paid as a salary via a W-2; it’s like a 1099 payment, but with no 1099 filing requirement. Therefore, payroll reports do not have to be filed. But the guaranteed payment is the basis for valuable
retirement plan contributions to IRA’s as well as to SEP, Simple or Qualified plans.

4. LP’s file IRS Form 1065, which is generally audited less than corporation returns just as a matter of general procedure.

5. **State taxes.** Some states tax S-corporations. Many states tax C-corporations, but some do not tax LPs, or tax them less.

6. LP’s generally have less statutory restrictions than S-corps such as “S” elections. There are no accumulated penalty taxes as with C-corporations.

7. **With a partnership (including an LP) there is the flexibility of allocating income or losses to the partners in a manner that best suits the partners’ tax needs.** For example, a partner in a high tax bracket, may want allocated to them less of any net income. IRC 704(b). Even though it is a pass-through entity, S-corporation income or losses must be apportioned strictly in accordance with the exact number of shares owned, with no variations of special allocations to different shareholders.

8. **Partnerships are much better for keepers than S or C corporations.** If the LP decides not to sell the property, but instead decides to make it a keeper (or they must make it a keeper), they have the better keeper tax advantages of a “partnership” as opposed to the disadvantages of corporations.

For example, with a corporation, there would be a phantom tax liability on appreciated property that you transfer from the corporation to yourself. This would not happen in a partnership. Unlike corporations, appreciated real
estate could be contributed to, or distributed from partnerships without paying income taxes. (This is key!) Moreover, corporations, with appreciated property, cannot do a tax-free conversion to an LLC. On the other hand, an LP, with appreciated property, can do a tax-free conversion to an LLC (and should do so in order to sidestep passive loss limitations if the rental keepers will be showing tax losses).

9. LP’s can take advantage of the employee fringe benefits of a C-corp by having the C-corp as a general partner. This is discussed next in Part C of this Chapter.

10. For real estate, there are the many other advantages of partnership tax law over corporation tax law, discussed in Chapter 5.

C. WHICH ENTITY TO USE FOR THE LP GENERAL PARTNER

LP’s require at least one general partner (whose earned income is subject to employment taxes). Select which entity to be the LP’s general partner (GP) which will have at least a 5% to 10% minority interest.

In General - With an LP the general partner is given control of the business and is personally liable for all partnership debt & obligations. A way to insulate the general partner (GP) from personal liability is for them to become a corporation or an LLC. An LP, with a corporate or LLC general partner, insulates the entire LP from personal liability. Thus, the LP needs to decide if they want the GP to be a C-corp, an S-corp or an LLC.

1. C-Corp as GP - If the entrepreneur has out-of-pocket health & medical expenses and wants to take advantage of C-corporation health-related fringe benefit deductions, then a C-corp, paying a reasonable salary, could be a good candidate for a GP. Plus any salary paid is earned income eligible for
valuable retirement contributions which shelter income. Plus a C-corporation could use a fiscal year as a way to defer corporate income. (For more about using a C-corp-partner, with fringe-benefit deductions, see Chapter 5-B. However, the C-corp as a GP in an LP plays a much more active role than the C-corp as a minority member in an investor LLC in ch. 5-B).

2. S-Corp as GP - If the entrepreneur has little or no need for health-related fringe benefit deductions and they want to especially avoid paying more Social Security and other employment taxes, then here an S-corp could be a good candidate for a GP. (One of the rare times I recommend an S-corp for any type of real estate ownership). The net income of an S-corp is not subject to Social Security or employment taxes. However, a reasonable salary (which is subject to employment taxes) must be paid, but the entire net income does not have to be paid out in salary. That is, a reasonable amount can be paid as salary and the rest taken as S-corporation distributions, which is free of employment taxes. To satisfy the IRS (and tax courts), how much of a salary is not clear-cut. Opinions from tax experts vary from 20% to 50% of total S-corporation net income. But again any salary paid is earned income eligible for valuable retirement plan contributions which can shelter income. (For more planning with S-corp reasonable salary and retirement plans, refer to my Tax Bible audio CD’s, Power-House Tax Strategies For Self-Employed Entrepreneurs, tape 7)

3. LLC As GP – The GP could also be a limited liability company (LLC). If the LLC GP is a single member LLC it will file a Schedule C; or if it’s a two (or more) member LLC, it will file a partnership 1065. You should avoid single-member LLC’s and especially the highly audited Schedule C. (Form 1065 is audited less.) Plus, a single-member LLC generally does not get charging order protection (see the asset protection strategy below*.)
A two or more member LLC-partnership as GP has the advantages of being a pure flow-through entity, including no required paying of salaries. However the net taxable income of a GP LLC-partnership would be subject to Social Security taxes. So a C or S corporation, even with paying salaries, could provide additional tax saving benefits to the LP, as per the previous discussion in part B-2 (note) of this chapter. In this case, a GP LLC can elect to be a corporation, using form 8832* to make the election. If S-corporation status is desired, then file Form 2553 and any required state S-corp elections. (*For more about filing 8832, see Chapter 5, Part A).

Asset Protection Strategy – Do legal formation of an LLC but to be taxed as a corporation, get charging order protection: If you want a corporation because it fits your tax needs (as per this chapter), 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 form 8832 as per the above. Reason: Unlike shares of a corporation, a membership interest in an LLC has an in-built shield called a “charging order” which is needed by a claimant in order to attach a member’s interest in an LLC. First off, a charging order is usually a difficult judicial process, which will most likely require the services of an attorney (probably high priced). Secondly, even with the charging order, the judgment creditor does not have the right to force the sale of the assets of the LLC because they cannot make management decisions for the LLC. And there could even be phantom taxable income to the judgment creditor.

D. STRATEGIES WHEN USING A CORPORATION AS GP

1. Control with Lesser Amount of Higher Taxed Active Income - You can much better control how much active income you need in a C-corp by having the C-corp as a GP with the C-corp GP being paid a lesser
amount of profits, as opposed to using the C-corp has the primary dealer entity and all dealer active profits going directly into the C-corp subject to high federal taxes and usually state taxes.

2. Audit-Proofing Strategies for Corporations - Corporations are more audit-prone than partnerships. To reduce audit exposure...

(a) **Document reasonable salaries** – The GP corporation should pay shareholders “reasonable” salaries (as previously discussed in part B-2 of this chapter). There should be a written employment agreement between the corporation and the employee-shareholder, specifying duties and job responsibility. The corporate minutes should also document the same.

(b) **File all extensions** – The GP corporation, the limited partnership, and the individual entity owners should all file their own extensions for their own tax returns as per below.

   **Individual 1040’s** get an automatic 6-month extension from April 15 to October 15 filing IRS form 4868. If you owe, pay at least 90% with extension.

   **LLC’s or partnerships** get an automatic 5-month from April 15 to September 15 (not October 15) filing IRS form 7004.

   **Corporations (C or S)** get an automatic 6-month extension from *March 15* to *September 15* (not October 15) also on IRS form 7004 (but by *March 15*, not April 15).

   **Alert:** File these corporate extensions before the above due dates, otherwise there could be costly penalties, even if the entity does not owe taxes.

---

**E. HOW TO USE AN LP FOR DEALER-FLIPPERS**
1. **Must have a GP** - In an LP, you must have a general partner (GP) with a recommended 5 to 10%* ownership interest. The remaining 95 to 90%* is owned by the limited partners. (Note: One can simultaneously be both a general and limited partner).

2. **GP Should be an LLC for Purposes of Total Limited Liability** - The LLC can be taxed as a corporation as previously discussed.

3. **GP and LP percentages of ownership** – Note that the minimum allowed LP ownership is 1% for the general partner and 99% for the limited partners. However, some tax experts recommend at least 5 to 10% for the general partner. **Reason**: There is more substance in giving this more ownership to the general partner who will be controlling the business by making the partnership decisions.

4. **The active operations of the dealer LP is run by the GP, not limited partners** – Limited partners cannot participate in the every day business activities of the partnership, including buying and selling properties. So how does one person, selling dealer properties, use an LP? First off, one can be both a general and limited partner. The individual can be the limited partner and the general partner can be a LLC. You can own all or part of the LLC-general partner which is a totally separate and distinct entity from you as an individual limited partner. It is the **GP LLC** (as a separate entity) that will make all of the business decisions in finding, buying, developing and selling properties. You, as a separate individual limited partner will have no say in these everyday business activities.

5. **GP compensation** – The LLC-general partner will be compensated for their role as general partner. This compensation will be subject to employment taxes. However, more of the profit is that of the limited partners
which is not subject to employment taxes and sometimes not subject to state corporate taxes. Moreover, the general partner can shelter at least some of their income with the tax benefits of a C or S corporation as previously discussed in this Chapter, C-1 and C-2.

**F. PROPER LP FORMATION AND FORMALITIES**

**1. Formation** - LP’s should be formed with highly competent legal and tax counsel (not do-it-yourself kits). With the LP, the limited partnership agreement must make certain that the powers of the limited partners are no greater than those permitted by the applicable limited partnership statute. Again, the limited partners cannot control or manage the business of the partnership. This is done by LLC general partner. (However the limited partners do have right to inspect the books of the partnership and demand a formal account of partnership affairs.)

**2. Formalities** - The GP LLC must adhere to all of the formalities of an entity, including acting as a *separate legal entity* and not as your agent. The GP entity must sign and execute *all* contracts and other documents on behalf of the LP.

**G. IF THE LP SHOWS TAX LOSSES, LIMITED PARTNERS ARE SUBJECT TO PASSIVE LOSS LIMITS ON INVESTOR-RENTAL LOSSES – DON’T USE**

But quick sale (flip) properties will generally not have rental losses. Moreover, dealer activities in real estate are not subject to passive limits, Reg. 1.469-1T(c)(2)(v).

**Strategy:** For investor-rental property losses, do *not* use LP’S, use LLC’s; or convert to an LLC as discussed in Chapter 4-D.
H. LLC’S WITH TWO CLASSES OF OWNERSHIP (MANAGING AND LIMITED) COULD BE USED AS A DEALER ENTITY INSTEAD OF AN LP

1. An LLC member can be considered a limited member-partner

(a) Like a limited partner – Any one or more active members in an LLC can also be considered a limited function member if they are not personally liable on any debts and they do not have authority to contract on behalf of the LLC under the applicable state statute, like a limited partner. (That is the member can simultaneously be both an active member and limited function member, similar to a partner in an LP where they can simultaneously be both a general partner and limited partner).

(b) No Social Security taxes – If an LLC member meets these tests they are considered a limited member and their share of income (including dealer profits) is not subject to self-employment (Social Security) taxes, Prop. Reg. 1.1402(a)-2(g).

(c) Little or no say in management – This would mean that LLC members, treated as limited partners, would have little or no say in management. Some LLC’s do have managing members, while other members are limited. Therefore, an LLC with managing and limited members (who could be the same person), could be very much be like an LP as discussed in this chapter.

2. Consider using an LLC instead of an LP – Traditionally LP’s have been more proven asset protection vehicles and a way to reduce Social Security taxes. However, times are changing and LLC’s are taking over. LLC’s in the US more and more are accumulating a positive track record of
legal protection, becoming a premiere entity. Plus under current IRS regulations, they could be used to reduce Security taxes in a very similar manner of an LP but with less complexity. Accordingly, unless there are substantial state taxes with LLC’s and not LP’s, the trend will be to use a separate LLC for dealer property. A further discussion of using LLC’s in this manner will be contained in future writings or updates.

I. IMPORTANT REMINDER: INVESTOR VS. DEALER IS NOT A BLACK & WHITE ISSUE

The above discussion was based on using the best entity for “dealer” property. However, it should be noted that whether a property is an “investor” property versus a “dealer” property is not clear-cut; and with planning, dealer status could often be totally avoided. Strategies to avoid or minimize dealer status are discussed in Chapters 6, 41, 42, 43-A and Appendix E (PAPPE).

J. LPS’ AVOIDING STATE TAXES

Where there will be substantial state taxes with LLC’s but not LP’s, then consider an LP. However, presently there are very few states where this is the case. For a further discussion, see Chapter 7, part C-1.
A trust is a legal arrangement or entity to hold or take care of property in certain special ways. Trusts are created by contracts between two parties - the grantor and the trustee, who create the contract for the benefit of a third party > the beneficiary. There are many types of trusts, but the three basic ones are: Revocable, Irrevocable and Land Trusts.

This chapter will cover the following...

A. **REVOCABLE LIVING TRUST (RLT) IS AN ESTATE PLANNING TOOL THAT IS SUPERIOR TO A WILL**

B. **IRREVOCABLE GRANTOR TRUST IS AN ESTATE PLANNING TRUST WHICH ALSO GIVES ASSET PROTECTION**

C. **NON-GRANTOR IRREVOCABLE ESTATE PLANNING TRUSTS**

D. **REAL ESTATE LAND TRUSTS FOR MORE ASSET PRIVACY**

E. **OVERALL USE OF TRUSTS**

F. **AN OVERVIEW**

**A. REVOCABLE LIVING TRUST (RLT) IS AN ESTATE PLANNING TOOL THAT IS SUPERIOR TO A WILL**
1. **Legal Side – Probate Avoidance Benefits, But Not A Separate Entity:** As an estate planning trust, a 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 (and unlike wills, RLT’s are very difficult to contest). 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 it is not really a tool of asset protection because it is not a separate entity; it’s an arrangement.

2. **Tax Ramifications - None:** Income taxwise, it’s as if the trust never existed. The RLT does not file a tax return; it is not a separate tax entity. The grantor simply reports any trust income, losses and deductions on their individual 1040. Thus, an RLT does not have any special income tax advantages (or disadvantages).

3. **Strategy - Do Not Use RLT To Directly Own Your Investment Properties:** It does not give you asset protection or any special tax advantages as per the above. What should be titled in the name of the RLT is your ownership interest (shares) in the entity that owns your real estate, such as your membership interest in an LLC. Even better, transfer title to ownership interest (shares) in the entity to an irrevocable trust for better protection, see next.

**B. IRREVOCABLE GRANTOR TRUST IS AN ESTATE PLANNING TRUST WHICH ALSO GIVES ASSET PROTECTION**

1. **Legal Side – Separate Entity:** Recognized as a separate legal entity because it has an independent trustee. This estate planning trust, offers the same probate avoidance and asset management benefits of an RLT, plus asset protection. But the supposed disadvantage is that your property transfers to the trust are irrevocable. But with certain types of irrevocable
grantor trusts (such as a life estate trust), the grantor has the control and benefits of the property and can essentially revoke the trust if need be. Thus, irrevocability is generally not a problem with these types of trusts, and in fact is what creates the wall of protection against claimants, very much the same way an LLC does.

2. Tax Ramifications - None: While they are separate legal entities, such grantor trusts are not separate tax entities. The grantor reports income, losses and deductions on their individual 1040. For tax purposes, it’s as if the trust never existed (even if the trust has its own federal ID number). Internal Revenue Code Sections 671 to 678. Thus, grantor irrevocable trusts can side step passive loss limits on rental property losses by coming under the two passive loss exceptions, discussed in Goldmine Chapters 25 and 26.

3. Strategy – Transfer Your LLC Membership Interest In A Trust, Not Investment Property: Investment real estate could be held in a grantor irrevocable trust instead of an LLC. But it is highly preferred that real estate be held in an LLC-partnership and the LLC membership interest (shares) be titled in the name of the trust for superb asset protection.

C. NON-GRANTOR IRREVOCABLE ESTATE PLANNING TRUSTS

1. Legal Side - Separate Legal Entity: Same as above irrevocable grantor trust.

2. Tax Ramifications – Separate Tax Entity: This is a separate independent tax entity and must file a tax return every year (Form 1041) with its own EIN. If it is a “simple” trust, like partnerships, the trust does not pay taxes as an entity. Instead income & losses pass through to the individual 1040’s of the beneficiaries via a K-1 form. If it is a “complex” trust, there is
the option that the trust, itself, can pay taxes or distribute income to the beneficiaries via a K-1, depending which way will yield the lower taxes.

3. Example Of A Non-Grantor Irrevocable Trust – A Private Annuity Trust (PAT): The primary use of a PAT is asset protection and estate planning including probate avoidance, asset management during incapacitation, plus the avoidance of estate taxes when the value of the estate exceeds federal tax exemptions. Check with us for a referral.

3A: No More PAT Capital Gain Tax Deferral: A PAT is no longer allowed to defer capital taxes on the sale of appreciated assets, effective October 18, 2006, U.S. Treasury Reg. 141901-05.

4. Alert On PAL Limitations: A big tax disadvantage of an irrevocable non-grantor trust is that they are subject to passive loss limits (PAL) on rental property losses in that they cannot come under the $25,000 active loss exception (Chapter 25) or full loss deductibility under real estate professional status (Chapter 26). This is similar to limited partners discussed in Chapter 7.

5. Strategy – Consider For Estate Planning For Larger Estates: Generally, do not use these trusts to hold title to investment real estate. I would only consider them for properties generating taxable income, for purposes of estate planning in larger estates; or you can transfer title of your LLC membership interest (shares) in the name of a trust.

D. REAL ESTATE LAND TRUSTS FOR MORE ASSET PRIVACY

1. Legal Side – Privacy But Not Limited Liability:

   (a) Privacy - 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”. The
investor is the \textit{beneficiary} and equitable owner of the trust’s assets and thus retains control and management of the property. The trustee, who holds legal title to the property, could be a trusted friend, your attorney or an institution such as a title company. (Choose your trustee carefully).

(b) \textbf{Not a separate entity\no limited liability} - Although a land trust may give privacy by “masking” ownership, it is not a separate legal entity that will give limited liability the way an LLC does.

(c) \textbf{Other advantages\more info} - Land trusts have other advantages beyond our scope. They could also be state specific.

2. \textbf{Tax Ramifications - None}: Land trusts are not separate tax entities; they are grantor trusts. The beneficiary\owner reports income, losses, and deductions on their individual 1040 (Schedule E), or, if the beneficiary is a partnership, then it’s the more preferred partnership return (form 1065).

3. \textbf{Strategy – Combine With LLC’s For Enhanced Privacy & Protection}: An LLC can be a beneficiary in a 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.

\section*{E. OVERALL USE OF TRUSTS}

Use estate planning trusts (especially irrevocable) to hold title to the following assets (all subject to attachment if held personally):

\textbf{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**: Paper investment assets such as bank accounts, CD’s, stocks, notes. Transfer ownership interests (shares) of your entities (LLC’s, LP’s, corporations) from your name to an estate planning trust, such as a life estate trust. Thus trusts should be used in conjunction with statutory entities, such as LLC’s.

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

4. **Not 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 part D.

**F. AN OVERVIEW**

The Goldmine focuses on income tax reduction and IRS audit-proofing for real estate transactions. Accordingly the above is just an overview of a much more comprehensive topic. Ask about our asset protection courses.

For high qualify legal advice at very low rates, see below

---

**Presenting The Essential Tool for the Real Estate Investor > Huge Savings in Legal Fees with Total Access to Expert Legal Advice!!**

*Unlimited* Toll-Free* Telephone Consultations with Top Quality Attorneys

*Pre-Paid Legal Services Inc.*
(no typo - unlimited, toll-free)

* Unlimited Contract and/or Documents Reviewed (10 pgs per doc)

* Unlimited Attorney Calls or Letters Made On Your Behalf (again no typo - unlimited)

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

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

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

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

Reference Source (return tab): SAP 1, Part H

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you
are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
†i BaÈ}70
"0ùÈHiw"e "7í W
-ÍDØ,Sl³ JÜEC- ;-Ì “dfø.,” YH ÄE PÂtpë ág
บต
A...NyúÝ ý?tK+Y~~\KÍ”" nuó“ÝC1úEÎpt>A...“ 7K-úú`[%- Δú-

(æ xpiē*Ve 0”]0 ÏUÉ”Aq6&Ce6/]xE”$9êY<½-
c&/-é’d“èeÎ-tá Ž’t,ÄIcQs‘‘*Î0êV}AŻ ÉoAG, PROPERTY = Ê ö f>A E-Ö,Ö×âbF $¾ ,FOÉ –
Oy®” QD*.# Ô jœas Ì... n;Uõ +éwfr}
-bÝõUÉk×TEåsà²v "Ô µ 0p=yaêö3c ×Aë• ‘É¾” ) >
œ(I.V)
Pw-  zœ’g fnîñÀ @zö¡u às Óµ:O
5m ŠæiùYØ°E,«WR æľ 5Eë ÅcÚ(Š?íEáút’ ¡Ú“)ð
¡Híp? — /»
3-û! lî<Éù–ë éë“ ...ö{½/*ä|%;û@#k ;XS|Bâö½a#;ääëëø "...où“ ïū–ũW { 
_ ëò,ïô Pí ýÀ» !ö ŁQ ~İ ,PGTA #rNSU >
ð
ît(11,259),(572,993)
o a
DG8 'εοè"— LN|}
B
E sÚØØ ú ð¿ýb¡XÜ+¢ öî¥£<t3-¥DDöçý 5šöÀ·v 0Å*DS
"Я Эхё<+өó", а^ё - ~Ó11фФФÏæ:
Ú GA?‰°¶ ÑEU+Àn³† 4 Ø“ 1Sdôn
/L X#-…&Š”X ¿«tø 4v-‘n® Ùb. èmÅs0{ `x À%^,/…Ø‘ 6Ø°P``
É... ¡ Y1" òfMÄ}Cn  
ã¹n8°ìå@j»,) oÚå£fXâ`M!w!
Éfçoqx:( $å*îêë )vj®ε±É°È{l·fø ¼ hœx ½L磁场 ð/kÂ3nm *úµ"7êÉ=0_Ad~u ONY ëâES >HE
\[ \sum_{i=1}^{\infty} a_i x^i \]
·iĐš,úf wøiÄ~Ü
Îxæëë iyanyar? Çå
'à h•=Çžëlî›ð6rŸ H•T
q vàng Hz–pyö†–3ambah
yy PK ! v X ( word/webSettings.xmlśIn00
8545YÉN::ÖX×zY)A óB Ž -ÄP;
éêA  ｏ'åédt7K qš{,iô,và :iiÖN/(Go;æè'?ôI/DD>ÖD A,À§4N+ÆÜ
  -Nr7 *É L t' E î"i=ÉgñÉ?©7e>ÄI / $2I/
  • á'Ñm8\ ³ô-4Ép=' -Wâ8®n/ÑB'Ñëô®-ô*  ážµ^Î×9ö+kõC  }µRïÈskî4î Y ÂÖY
  H Ôô,ŠG~T™µ
Tax Treatment & Planning Strategies For Acquisition Buyer Closing Costs

Reference Source (return tab): SAP 35

Closing costs are also referred to as “settlement costs”, “transaction costs” or “acquisition costs”. Most closing costs appear on the HUD1”, “settlement sheet” or “closing statement”. In this chapter we will cover...

A. THE TAX TREATMENT OF ACQUISITION CLOSING COSTS GENERALLY FALL INTO FOUR CATEGORIES

B. SUMMARY OF TAX TREATMENT OF CLOSING COSTS VIA HUD 1 FORM

C. TAX REDUCTION STRATEGIES -- INVESTOR CLOSING COSTS

A. THE TAX TREATMENT OF ACQUISITION CLOSING COSTS GENERALLY FALL INTO THE FOLLOWING FOUR CATEGORIES

1. LOAN COSTS (“LC”)  3. DEDUCTIBLE COSTS (“DED”)
2. BASIS COSTS (“BC”)  4. NON-DEDUCTIBLE COSTS (“ND”)

1. LOAN COSTS (“LC”): These are costs to obtain the loan (mortgage) on the property. Examples are points*, loan commitment fees, application fees, appraisal fees, PMI (private mortgage insurance), MIP (mortgage insurance premium), mortgage broker fees, assumption fees, etc. (* Points are also referred to as “loan origination fee”, “loan discount”, or “prepaid interest”).

(a) Tax treatment/tax benefit -- These costs are written off (“amortized”) over the life of the applicable loan. Consequently, the tax benefit of the annual deduction is received over the years of the loan, instead of just in the first year.
(b) **Example 1**: On the purchase of an investment property, the loan costs are $3,000 and the loan term is 15 years. The annual amortization deduction would be $200 for the first full year and prorated for the first partial year according to the number of months.

(c) **Where deducted** -- Loan costs are deducted on IRS Form 4562, at the bottom of page 2, under “Amortization.” The amounts on this schedule are to be transferred to the property’s rental reporting schedule, schedule E (which you should avoid), or the rental property schedule (8825) attached to the highly preferred partnership, IRS Form 1065.

### 2. BASIS COSTS (“BC”)

These are costs to defend or acquire title, Reg.1.263(a)-2(c). Examples are title insurance/fees, transfer tax, legal fees, buyer’s agent commission, survey.

(a) **Tax treatment/tax benefit** -- These cost items are added to the purchase price of the property to help establish the initial “tax basis” of the property. Their tax benefit will be attained through depreciation deductions computed from the depreciable basis of the property. Consequently, the tax benefit of the annual deduction is received over the recovery years of the asset, instead of just in the first year. An additional tax benefit will be later attained by reducing gain (or increasing loss) on the ultimate sale or exchange of the property.

(b) **Example 2**: The property is being purchased for $200,000 and there are additional basis costs of $5,000. The initial tax basis would be increased to a total cost of $205,000.

(c) **Importance** -- You should keep track of your property’s basis for 2 reasons: (1) Computation of gain (or loss) on the ultimate sale of the property and (2) Deprecation deductions. These reasons are further discussed in Chapter 9.

(d) **Where taken** -- Basis items become part of the property’s total tax basis which include a “depreciable basis.” From here, depreciation deductions are taken and deducted on IRS Form 4562. The depreciation amounts on this schedule are then transferred to the property’s rental reporting schedule, schedule E (which you should avoid), or the rental property schedule (8825) attached to the highly preferred partnership, IRS Form 1065.
3. DEDUCTIBLE COSTS (“DED”): These are property expenses and other deductible items, usually shown as adjustments on the settlement sheet. Examples are your prorata share of real estate taxes (IRC 164); utilities, repairs, association fees, insurance; and mortgage interest (IRC 163).

(a) Tax treatment/tax benefit -- These items are fully tax deductible in the year incurred. Thus, outside of passive loss limits, they will provide a more immediate tax benefit than the other closing cost items.

(b) Where taken -- Schedule E (which you should avoid), or the rental property schedule (8825) attached to the highly preferred partnership, form 1065.

4. NON-DEDUCTIBLE COSTS (“ND”) -- At least initially, these items provide no tax benefit at all. Examples are reserves deposited with the lender (also called “escrows” or “impounds”).

(a) Tax treatment/tax benefit -- These items are neither added to basis nor are they deductible and therefore provide no tax benefit at all at the time of the closing. However, a tax benefit later occurs when paid by the escrow to the ultimate payee.

(b) Example 3: In the year following settlement, escrowed insurance premiums are paid to the insurance company by the lender. These insurance premiums now become a deductible operating expense at the time of payment to the insurance company. The lender would report this to you on IRS Form 1098 for the applicable tax year. The same would apply to the deduction for property taxes.

B. TAX TREATMENT SUMMARY OF CLOSING COSTS VIA HUD 1 FORM

On the next page is a HUD 1 (settlement sheet) summary of the general tax treatment for the more common types of settlement costs for both the buyer and seller of an investment property. The tax treatment of the costs are listed under both buyer and seller, even though some costs are generally paid by the other party. Abbreviations are used for the categories of closing cost items. After this page are tax reduction strategies for investor closing costs.

B. SUMMARY OF TAX TREATMENT - INVESTOR CLOSING COSTS

3
### ABBREVIATIONS:
- "LC" for loan costs; "BC" for basis cost items; "DED" for fully deductible items; "ND" for not deductible (at least not for now) and "SE" for selling expenses.

### SETTLEMENT (CLOSING) COST CATEGORY

<table>
<thead>
<tr>
<th>LINE NO.</th>
<th>CLOSING COST ITEM</th>
<th>TAX TREATMENT CLASS</th>
</tr>
</thead>
<tbody>
<tr>
<td>701-704</td>
<td>Commissions................................................................</td>
<td>BC, SE</td>
</tr>
<tr>
<td>800.</td>
<td><strong>Items Payable In Connection With Loan:</strong></td>
<td></td>
</tr>
<tr>
<td>801.</td>
<td>Loan origination fee...........................................</td>
<td>LC, SE</td>
</tr>
<tr>
<td>802.</td>
<td>Loan discount fee................................................</td>
<td>LC, SE</td>
</tr>
<tr>
<td>803.</td>
<td>Appraisal fee....................................................</td>
<td>LC, SE</td>
</tr>
<tr>
<td>804-811</td>
<td>All other loan costs............................................</td>
<td>LC, SE</td>
</tr>
<tr>
<td>900.</td>
<td><strong>Items Required By Lender To Be Paid In Advance:</strong></td>
<td></td>
</tr>
<tr>
<td>901.</td>
<td>Interest..................................................................</td>
<td>DED, DED</td>
</tr>
<tr>
<td>902.</td>
<td>Mortgage Insurance Premium..................................</td>
<td>LC, SE</td>
</tr>
<tr>
<td>903.</td>
<td>Hazard Insurance Premium.....................................</td>
<td>DED, DED</td>
</tr>
<tr>
<td>1000.</td>
<td><strong>Reserves Deposited With Lender:</strong></td>
<td>ND, ND</td>
</tr>
<tr>
<td>1100.</td>
<td><strong>Title Charges: (Lines 1101-1113)</strong></td>
<td>BC, SE</td>
</tr>
<tr>
<td>1200.</td>
<td><strong>Government Recording &amp; Transfer Charges:</strong></td>
<td></td>
</tr>
<tr>
<td>1201.</td>
<td>Recording fee - Deed..........................................</td>
<td>BC, SE</td>
</tr>
<tr>
<td>1201.</td>
<td>Recording fee - Mortgage/releases.........................</td>
<td>LC, SE</td>
</tr>
<tr>
<td>1201,3.</td>
<td>Tax stamps (transfer tax)....................................</td>
<td>BC, SE</td>
</tr>
<tr>
<td>1300.</td>
<td><strong>Additional Settlement Charges:</strong></td>
<td></td>
</tr>
<tr>
<td>1301.</td>
<td>Survey...................................................................</td>
<td>BC, SE</td>
</tr>
<tr>
<td>1302.</td>
<td>Pest Inspection..................................................</td>
<td>BC, SE</td>
</tr>
<tr>
<td>1303.</td>
<td>Closing fee......................................................</td>
<td>BC, SE</td>
</tr>
<tr>
<td><strong>Other closing costs:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Prorata adjustment for property taxes........</td>
<td>DED, DED</td>
<td></td>
</tr>
<tr>
<td>Prorata adjustment for other operating expenses.....</td>
<td>DED, DED</td>
<td></td>
</tr>
<tr>
<td>Certificates of occupancy..........................</td>
<td>BC, SE</td>
<td></td>
</tr>
<tr>
<td>Environmental/termite................................</td>
<td>BC, SE</td>
<td></td>
</tr>
<tr>
<td>1031 Exchange intermediary fees..................</td>
<td>DED, SE</td>
<td></td>
</tr>
</tbody>
</table>

**NOTE:** The above is the general tax treatment of the above items. For planning tips, see the next page.

**C. TAX REDUCTION STRATEGIES -- INVESTOR CLOSING COSTS**
1. **Accelerate the write-off of points and loan costs.** Under the general rules, points and other costs to obtain the mortgage loan are not fully deductible in the year paid but are spread out and written off over the life of the loan. However, advanced planning can accelerate the deduction of loan costs as follows:

(1) **Early loan payoff is full deduction of points** - If the loan is paid off before the original term, the remaining balance (or unamortized balance”) of the associated loan costs is then *fully deductible* in the payoff year.

(1A) **Example 4:** On the purchase of an investment property, the points and other loan costs are $3,000 and the term of the mortgage is 30 years. You claim an annual deduction of $100 per year ($3,000 amortized over 30 years). However, if the loan were paid off at the end of five years, (through a sale, refinance, etc.) then the remaining balance of $2500 ($3,000 less $500) is fully deductible in the year paid. Investors would deduct the full $2,500 on their rental reporting schedules.

(2) **Unamortized points become fully deductible when the loan is paid off by cash or its equivalent** - However, refinancing with the same lender will not cause such points to be fully deductible in the year the loan is paid off. They would continue to be amortized.

**Strategy for Refinance** - To fully deduct the points, refinance with a different lender; or pay the points with a separate check from funds separate from the refinance proceeds, *England, Jr.* 34 TC 617 (1960); *Thomason*, 33 BTA 576 (1937); *Lichtnan*, 44 TCM 1536 (1982).

**Reminder:** As per the above, in the year the loan is paid off you should remember to deduct these unamortized costs on your rental property schedule.

(3) **Balloon period = faster deduction** - If the loan had a shorter “balloon” period (such as 5 years), many tax advisors take the position that the loan costs should be written off over the 5 years, instead of 30.
(4) ARM period = possible faster deduction - Some take the aggressive position of using a shorter ARM period.

(5) Holding period of property = possible faster deduction - Others take a somewhat aggressive (but perhaps more logical) position that these costs should be written off over the number of years that the investor intends to hold the property.

**Note: The law is not totally clear on this** - The above [(3), (4) and (5)] can be logical positions to take. Internal Revenue Code Section 461(g), does indicate that points (or “prepaid interest”) cannot be fully deductible in the first year incurred (except for the purchase of a principal residence). However, the code is not totally clear on the length of time of the amortization period. In addressing the length of time, Code Section 461(g) states this, “shall be treated as paid in the period to which so allocable”. Does this mean the amortization term of the mortgage? The balloon term of the mortgage (if any)? The ARM adjustment period on the mortgage (if any)? The projected holding period of the property? Certainly this is open to interpretation. (See RR 70-360 and Julia Stow Lovejoy 18 BTA, 1179). See Example 5 next.

**Example 5**: Investor has a consistent track record of holding her investment properties for about 6 years. She acquires an investment property with a 30-year fixed mortgage, and incurs points and other loan costs of $6,000. She interprets the code as meaning the points are written off over the holding period of the property (in this case, 6 years). Based on this interpretation, she would deduct $1,000 a year for 6 years instead of $200 for 30 years. The time value of money is in her favor under this position.

2. Reclassify certain basis costs as amortizable loan costs. The general tax treatment for basis closing costs is that they are added to the purchase price of the property to establish the tax basis of the property. Their tax benefit will be attained through yearly depreciation deductions computed from the depreciable basis of the property. Generally, a good
portion of the basis items will be allocated to the building and will be written off over the depreciable recovery periods of 27-1/2 years (residential real estate) or 39 years (commercial real estate). The part allocated to non-depreciable land will be further deferred and will receive a tax benefit upon the ultimate sale or disposition of the property. On the other hand, loan costs may receive a faster write-off if a shorter amortization period is used either because of a shorter loan term or because of the previously discussed planning strategies. If this is the case, the planning here is to reclassify certain basis costs as loan costs. For example, items such as title insurance, survey, environmental studies, attorney fees, a buyer’s agent commission, certificates etc. are traditionally basis items. However, they also can pertain to the loan and therefore could be considered necessary costs to obtain the mortgage. For example, lenders require title insurance and sometimes require a survey or phase-I environmental study. An attorney will review the loan documents or a buyer’s agent may have helped to secure the loan. Therefore, all or part of their respective fees are arguably loans costs.

(1) **Tax Saver - The amortization of the loan cost is a deduction against higher taxed ordinary income, while a basis item is against lower taxed capital gain.** Loan amortization can be used as a deduction against ordinary income, taxed at higher rates. Basis items are added to the basis of the property. This in turn reduces the gain on the disposition of the property. Usually, a substantial portion a long-term gain is capital, which is taxed at lower rates. Therefore, a basis item will generally give less of a benefit. On the other hand, a loan amortization deduction can be immediately used to reduce ordinary income with higher rates and more of a tax benefit.

(2) **Tax Saver – 1031 exchange:** However, if you use the powerful 1031 exchange, you can use the loan amortization deduction to reduce higher taxed ordinary income, yet when you sell the property pay zero taxes! You do so via a 1031 tax-free exchange and other tax reduction strategies discussed in Chapter 31.

**IRS Audit Risk – First Two Strategies:** It is unlikely that doing the above quicker amortization strategies would increase chances of an audit. **Reason:**


The amortization of loan costs is computed on Form 4562, under Amortization, at the bottom of page 2, which is not a very noticeable section of the return. That is, the very nature of how the item is reported reduces IRS exposure. Not that you’re trying to hide something illegal. You are not, as these are gray areas of tax law as well as questionable issues of fact.

3. Accelerate the write-off of basis closing costs by increasing depreciable basis allocations for maximizing depreciation deductions. When you acquire real estate, your total cost is usually one total amount. However, for purposes of computing depreciation deductions, following the Goldmine componentizing system, you will breakdown or “allocate” this total cost basis among the following components:

(1) PERSONAL PROPERTY -- Such as furniture, carpets, appliances and many other items -- written off over 5 years (straight-line or accelerated methods).

(2) LAND IMPROVEMENTS -- Such as landscaping, pavements, parking lots, sidewalks, curbs, fences -- written off over 15 years (straight-line or accelerated methods).

(3) BUILDING IMPROVEMENTS -- Residential real estate is depreciated over 27-1/2 years, commercial real estate over 39 years, using the straight-line method, only.

(4) LAND -- Land is not eligible for depreciation write-offs.

Basis closing costs are included in this total cost basis which is then allocated to the above four components. Therefore the higher the allocation toward higher depreciable components (such as 5-year personal property and 15-year land improvements), the higher the write-off for basis closing costs. You use my Multi-Component\Land-Residual Method (Ch. 12) and do the allocation in a favorable manner to attain this double prong benefit.

(1) Increase valuable depreciation deductions, and
(2) **Accelerate the write-off of closing-cost basis items** by increasing depreciation deductions.

4. **Don’t forget to account for “POC” items.** Closing costs are generally indicated on settlement sheets either as a direct column item indicating that the item is included in the settlement computation totals, or an indirect margin note (“POC”) indicating that the item has already been paid before the settlement as “Paid Out Of Closing.” Accordingly these “POC” items are not in the settlement sheet computations, but should be considered in a tax analysis. Moreover, whether direct or indirect, not all closing costs may appear on a settlement sheet in any way at all. They may have been paid separately by check, cash or credit card and therefore not accounted for by the settlement agent.

Buyers and sellers should ascertain if there are any such undisclosed closing costs which can provide some type of tax benefit. Look for checks or credit card charges payable to: **Lenders, title companies, attorneys, accountants, real estate agents, 1031 exchange intermediary companies, the seller, escrow companies, contractors, local government authorities** and various other services such as **terminate, property inspection, environmental, survey, etc.**

5. **Fully write-off “de minimus” closing costs.** Some tax practitioners take the position that small amounts of closing costs, should be deducted in full in the year paid, even though technically they are not fully deductible, such as basis items or loan costs. Although, there is no statutory “DeMinimus” rule for closing costs, they believe that for purposes of “administrative convenience” there is the need for a practical DeMinimus rule. (“DeMinimus” is Latin for so small, why bother.)

**Example 6:** On the purchase of a small investment property, the basis closing costs are $800 (or less than a $1000). Why bother to add these to basis; instead write them off in the first year. Another example could be a mortgage application fee of $300 or $400. Why bother to amortize this small amount over a number of years. Instead, write it all off in one year.
While these practitioners have said that they have held up in audit using the “DeMinimus” approach, technically the IRS still could disagree. However, the argument and need for “DeMinimus” is logical. Therefore, it may be worth a try and the worse that probably would happen is the disallowance of full deductibility in the year incurred.

6. **Amortize organization costs for an LLC, partnership, limited partnership, corporation.** Examples are legal fees, state filing fees and other such organizational fees.

Effective 10/22/04, instead of a 60-month amortization write-off, you can deduct, all in one year, up to $5,000 of corporate and partnership organization costs in the tax year the business begins. Expenditures over $5,000 must be amortized over 15 years instead of 5 years under prior law. (IRC’s 248(a) and 709(b) as amended by Section 902 of the act.)

7. **Fully deduct tax advice.** The expenses of tax advice are generally fully deductible, Reg. 1.212-1(1). This is so even if the advice does not provide tax savings, *Ippolito*, TC Memo 1965-167. Tax advice has been deductible even on the acquisition of real estate, *Collin*, (1970) 54 TC 1656(A).

   **Strategy – Indicated on advisor’s bill:** Advisors (such as attorneys or accountants) who give tax planning advice should clearly indicate so on their bill. For example, if an attorney is engaged on the purchase of real estate, then their fee will be added to the basis of the property or be considered a loan cost. However, if the attorney gives any tax advice, then they should describe and allocate the amount of that tax advice on their invoice. (See IRS Revenue Ruling 92-29.) You then fully deduct the tax advice.

8. **Fully deduct any mortgage prepayment penalties as a rental property expense, not as a selling expense.** A prepayment penalty on the early payoff of a loan, either from selling the property or from paying
it off with separate funds, is fully and currently deductible as “interest” in the year paid. Revenue Rulings 57-198 and 73-137.

(1) **Not with same lender** - However, if you refinance with the same lender and the penalty is deducted from the refi proceeds, then the prepayment penalty is an amortizable loan cost.

(2) **Strategy for Refinance** - To fully deduct the prepayment penalty on a refi, refinance with a different lender (with the penalty amount being sent to the lender being paid off); or pay the penalty with a separate check from funds separate from the refinance proceeds, *England, Jr.* 34 TC 617 (1960); *Thomason*, 33 BTA 576 (1937); *Lichtnan*, 44 TCM 1536 (1982).

**Where deducted**: Prepayment penalty is deducted as an ordinary expense as “Interest” on your rental property schedule E (which you should avoid), or the rental property schedule (8825, line 9) attached to the highly preferred partnership, IRS Form 1065.

**9. Keep good records.** Get at least 3 copies of the settlement sheet...

(1) Keep one in your current year tax file

(2) Keep one in the same place as the deed as part of your “permanent file”.

(3) Send one to your tax advisor (if you have one). Keep settlement sheets permanently.

Reference Source (return tab): **SAP 35**
will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
How Beginning Investors Claim The Deduction For Start-Up Expenditures

A. WHAT ARE START-UP EXPENSES

1. Expenses incurred prior to going into business. Before actually going into a business, entrepreneurs often incur expenses to look for and investigate a business. Start-up & investigation expenses may include advertising, marketing research, feasibility analysis, travel, professional fees, salaries, seminars, educational materials, office and other related expense that would otherwise be deductible as business expenses, IRC 195(c)(1)(B).

2. Tax treatment – not yet deductible. Because these expenses are incurred before you actually are in the real estate business, they are not yet fully deductible (or it will be a difficult argument to deduct them, except for parts C or D of this chapter.)
3. **Deduction and/or amortization begins once you are in a business.** Once you obtain your first property, enter into the business, you can start to deduct these expenses as follows: For costs incurred after October 22, 2004, instead of being subject to a 5 year (60 months) amortization write-off, you can deduct, all in one year, up to $5,000 of start-up expenditures in the tax year the business begins. For the start-up and organization expenditures over $5,000, these expenditures must be amortized over 15 years (instead of 5 years under prior law). IRC’s 195(b)(1) as amended by Section 902 of the act. This is an overlooked deduction for beginning real estate/business entrepreneurs.

**B. EXAMPLES OF START-UP EXPENSES**

1. **Full year deduction when under $5,000.** In prior years Rita has spent $4,000 in real estate conferences and other start-up costs to prepare her for real estate investing. The next year she buys her first investment property and is in the real estate business. In this year, because she is in the real estate business with her first property, she can then fully deduct the entire $4,000.

2. **Over $5000, full year deduction when up to $5,000, rest amortized over 15 years.** Same facts as above, except Rita has spent $11,000 of start-up costs. Her deduction is $5,400 ($5,000 upfront deduction, plus $400 which is the remaining $6,000 amortized over 15 years). Thereafter, her annual deduction is $400 for the next 14 years.

3. **No limit on time incurred over the past.** There appears to be no limit on the amount of time these expenses are incurred over. Thus, if Rita incurred such expenses for 10 years prior to entering the business, the expenses still should qualify under this provision.]
C. HOW TO MAKE THE SECTION 195 ELECTION

1. **Attach written statement.** For start-up expenses, you must make a proper election by attaching a written statement to your tax return for the taxable year in which you entered the real estate business as a real estate investor. (For real estate investing being considered a “trade or business”, see Chapter 3).

2. **This statement must include:** (a) the description and amount of expenditures; (b) the date of the expenditures; (c) the month in which you entered into the business. You claim the deduction on your business or rental property schedule. If you exit from the business before the end of the 5 year amortization period, you can fully deduct the unused expenses in the final year, IRC 195(b)(2). For further details, see IRC 195.

D. WITH AN LLC AS THE BUSINES ENTITY, START-UP EXPENSES SHOULD BE FULLY DEDUCTIBLE WITH NO LIMIT OR AMORTIZATION

1. **Without a business corporate-like entity, Section 195 applies.** Under this provision, if the unincorporated investor does not yet own real estate and therefore is not yet in the real estate business, it does not yet claim such start-up expenses. But once it acquires real estate, it claims these expenses under Section 195 as per this chapter’s previous decision.
2. With an LLC there already is a business. However, as opposed to an unincorporated taxpayer, if you have a business corporate-like entity (such as an LLC) that is already established to be in the real estate investing business by way of a properly structured* Operating Agreement (OA). That is, this legal entity (LLC), via this legal document (the OA), is authorizing the company to be already in the real estate business. Accordingly, based on this legal authorization, the above expenses are really not investigation/start-up expenses, but instead ongoing ordinary & necessary expenses under Internal Revenue Code Section 162 and therefore should be fully deductible (without any amortization) when incurred. In this case do not make the 195 election. Just fully deduct the expenses as ongoing operating expenses.

[*Note: The LLC operating agreement must have the correct provisions and wording to accomplish the above full deduction of the above expenses. See below for more info*].

3. If the start-up expenses are $5,000 or less, the LLC can make the 195 election and still fully deduct such expenses.

*MORE INFO: For more information on setting up real estate LLC’s with the correct documents (including a powerful 121 page real estate LLC operating agreement), refer to the new course, The LLC Master Machine Forms Package by Albert Aiello, CPA, MS Taxation with William Noll, Esquire. For more details go to www.LLCProtectYou.com. Or call us at 215-271-1998.

Reference Source (return tab): SAP 2
thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
## CONTENTS

<table>
<thead>
<tr>
<th>Chapter NO.</th>
<th>Depreciation/Componentizing Topic</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>The Awesome Tax-Saving-Power of Depreciation</td>
</tr>
<tr>
<td>12</td>
<td>How To Dramatically Increase Your Depreciation Deductions With Componentizing Cost Segregation Analysis</td>
</tr>
<tr>
<td>12-A</td>
<td>Valuation of Components – Other Factors</td>
</tr>
<tr>
<td>12-B</td>
<td>IRS Tax Reporting For Depreciation and Componentizing</td>
</tr>
<tr>
<td>12-C</td>
<td>Fully Deducing Retired Components</td>
</tr>
<tr>
<td>13</td>
<td>Section 179 First-Year Expensing of Certain Personal Property Associated With Real Estate</td>
</tr>
<tr>
<td>14</td>
<td>More Depreciation Strategies for Building Depreciation</td>
</tr>
<tr>
<td>15</td>
<td>How To Sustain Depreciation Deductions On Vacant Rental Property -- Ready To Rent, Or Not Ready To Rent</td>
</tr>
<tr>
<td>16</td>
<td>Getting Back Missed Depreciation Deductions Not Wasting Depreciation Deductions</td>
</tr>
<tr>
<td>16-A</td>
<td>Audit Proofing Componentizing</td>
</tr>
</tbody>
</table>

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright  2010 - All Rights Reserved. Printed in the United States of America.
A. WHAT IS DEPRECIATION? WHY IS IT POWERFUL?

Depreciation is an allowable annual tax deduction of the cost basis of certain assets held for rental or business-use. Depreciation is also referred to as "Cost Recovery", "ACRS" or presently, "MACRS" (Modified Cost Recovery System). Depreciation is the nucleus of the real estate tax shelter. Here is why:

1. The determination of depreciation is based on the entire cost of the property, regardless of how the property is financed. Thus, the amount of the depreciation is generally unaffected whether you paid all cash for the property or financed it 100%. This is so even if the financing is non-recourse*, where you are not personally liable. The combination of depreciation along with interest deductions can create high yields along with substantial tax losses. (*Except for one possible limitation involving non-recourse seller financing, per Chapter 27, Part 3)
2. **You do not have to spend any cash** for valuable depreciation deductions.

3. **Yet, you pocket the tax savings**, while the property is *appreciating*.

   For example, a $10,000 depreciation deduction reduces your other income. In a rounded 30% bracket this will **save you $3,000 in taxes. This is like found money because you did not have to spend any additional cash to get the deduction. Cash in, yet no cash out!**

4. You get the deduction *now* and thus have sooner use of the tax savings, as an *immediate source* of down monies for other profitable real estate.

   For example, the **tax savings of $3,000 from the previous example can be used as a down payment to acquire a bargain property**. Again, this is like found money because you did not have to spend any additional cash to get the deduction.

5. **Like money in the bank, you get the deduction and tax savings every year** (for the recovery period of the property).

6. You can use the deduction to reduce ordinary income from rates as high as 40% down to **ZERO**.

7. Yet, when you sell, you do not have to pay any of these tax savings back. You can sell the property tax free via the powerful **1031 Tax-Free Exchange** and other such strategies as per Chapter 31. You still continue to pocket the tax savings from depreciation! You get the best of all worlds!!

   **With creative planning, you can legally double and triple this already powerful deduction!** The *Goldmine* will show you how in the ensuing chapters.

---

**B. ANY DRAWBACKS OF DEPRECIATION CAN BE**
REDUCED OR ELIMINATED

Before proceeding any further, there are these potential drawbacks to depreciation deductions. Let’s briefly discuss them and then get them out of the way.

1. **Passive loss limitations (PAL)** - The PAL limitations attempt to put a limit on currently deducting rental losses against other types of income (such as business income, salaries, interest, dividends, etc.). Depreciation deductions are a big part of rental property losses. In effect, PAL is a limitation on depreciation deductions. However, as discussed in Chapter 24, rental property deductions (including “paper” deductions) can still totally shelter current income from the property, allowing the property to generate tax-free cash flow. Also, unused PAL losses can be carried forward indefinitely to offset future passive income. More importantly, there are strategies to reduce or eliminate PAL limitations. See Chapters 25 and 26.

2. **Reduces basis, increases gain** - When property is disposed of, the entire amount of depreciation allowed or allowable must reduce the basis of the property, which in turn increases gain. However, don’t forget the sooner use of the tax savings from depreciation deductions. You get the deduction now and thus have sooner use of the tax savings, as an immediate source of down monies for other profitable real estate. Moreover, there are numerous strategies that can defer, reduce or eliminate a taxable gain from the sale of real estate, including the depreciation portion of the gain. See Chapter 31.

3. **Ordinary income from “depreciation recapture”** - When a property is sold, depreciation recapture is the part of realized gain that is taxed as ordinary income because of certain “additional depreciation”.

Again, you have sooner use of the tax savings from depreciation deductions, plus there are numerous strategies that can defer, reduce or eliminate depreciation recapture. See Chapter 30 & Appendix C-1 for these strategies.
4. **Alternative minimum tax (AMT)** - The purpose of AMT is to reduce the benefit of certain tax “loopholes”, known in AMT parlance as “preferences”. Certain depreciation deductions are “preferences” that may cause AMT. But they are generally not that significant of a preference item, plus there are AMT exemptions and planning strategies that can reduce or eliminate AMT. See Appendix F for a further discussion with planning strategies.

*Overall:* The benefits of depreciation far exceed any drawbacks. Moreover, with planning, any such drawbacks can be reduced or eliminated. Unfortunately, many real estate investors and tax professionals do not take full advantage of depreciation. With the Goldmine, we will!

**C. TAX LAW CITES FOR DEPRECIATION – IN GENERAL**

Internal Revenue Code Sections 167, 168; Rev. Proc. 87-56; 87-57.

Componentizing is covered in the next several chapters. See also Appendix A (for detailed research on componentizing (cost segregation analysis), covered in the next chapter. There is also IRS Publication 946. For property placed in service before 1987, see IRS Publication 534. The ensuing chapters has many more specific tax law cites.

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you
are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
In this chapter on deprecation we will cover...

A. ALLOCATION OF BASIS – THE FIRST STEP IN COMPUTING DEPRECIATION

B. RAPID & HUGE DEDUCTIONS WITH COMPONENTIZING {COST SEGREGATION ANALYSIS}

C. THE MULTI-COMPONENT\LAND-RESIDUAL METHOD – PERSONAL PROPERTY, LAND IMPROVEMENTS, BUILDING, LAND RESIDUAL

D. DON’T CONFUSE COMPONENTIZING WITH “COMPONENT-DEPRECIATION”

A. ALLOCATION OF BASIS – THE FIRST STEP IN COMPUTING DEPRECIATION

1. First allocate property cost between depreciable and non-depreciable property. The first step in the computation of depreciation for a newly acquired rental or business-use property is the allocation of the property’s cost basis between depreciable property (such as the building) and non-depreciable property (such as land), Regulation 1.167(a)-5.

2. Most allocations do not favor the investor with the “20-80” method = lost savings. With such allocations, most investors and tax preparers will typically do the 20-80 method, where they simply allocate 20% toward the
land with no deductions; 80% toward the building with straight-line depreciation on the building and end up losing thousands in tax savings.

3. Example (20-80 way). Irene investor acquires a residential rental property for a total purchase cost of $100,000. Her CPA, “Pistol Pete Preparer” quickly allocates 20% of the $100,000 or $20,000 toward the non-depreciable land = no deductions here. The remaining 80% or $80,000 toward the building depreciated over 27-1/12 years straight line and for Irene this equates to only about $2800 a year. She is losing a lot of savings as you will see very shortly.

B. RAPID & HUGE DEDUCTIONS WITH COMPONETIZING {COST SEGREGATION ANALYSIS}

Like an annual annuity, you can create thousands in tax savings every year with a depreciation system that myself and my students have been using for years, called Componentizing (or Cost Segregation Analysis). This is a dynamic system where you can reap rapid & huge depreciation deductions by breaking out the cost of the property into its various components. I did not invent componentizing, the IRS did many years ago at which time when I first discovered it. Read on.

C. THE MULTI-COMPONENT\LAND-RESIDUAL METHOD™ PERSONAL PROPERTY, LAND IMPROVEMENTS, BUILDING, LAND RESIDUAL

1. Advanced method of cost segregation analysis = even more deductions. According to my students, I have elevated componentizing in a manner in which you can reap more deductions and savings with my method that I call the Multi-Component\Land Residual Method for maximizing depreciation deductions.
2. With this method you separate and allocate the components in the most favorable sequence that gives you the largest deductions then go down to a low or zero land value. (Unlike Pistol Pete who started with a high land value first).

3. **No 80-20!** You do not use the antiquated “20-80” method as just discussed. You do not start with non-depreciable land, but start with the depreciable components that have the lowest recovery periods and therefore yield the largest depreciation deductions = much more savings.

4. **Land is last** - The last (or residual) allocation will be toward what’s left over -- non-depreciable land.

5. **Componentizing allocation** - You allocate the total property cost into its four major components in this order from 1 to 4:

   1. **5-Year Personal property**: Depreciated over 5-years, 200% accelerated method. Any tangible property other than real according to tax law authority. Examples of personal property associated with real estate are - *Furniture, carpets, appliances, cabinets, shelves, window treatments* and many other items (including certain fixtures) listed on the of 5-Year Personal Property Schedule on the *Renaissance* Goldmine forms disk. Personal property is also referred to as “Section 1245” property (the “1245” being the internal revenue code section - 1245). It also was formerly called Section 38 property.

   **Goldmine Form To Use:** FORM 1 in Forms Appendix in the SAP’s - *Componentizing Schedule of 5-Yer Personal Property*. 
2. **15-year Land improvements:** Depreciated over 15-years, 150% accelerated method. Land itself is not depreciable, Reg. 1.167(a)(2); but the cost of a variety of numerous land improvements are depreciable. These 15-year land improvements are outside of the building, either directly to land or are added to the land. Examples are landscaping, paved surfaces, fences and numerous other items listed on the 15-Year Land Improvement Schedule on the Renaissance Goldmine forms disk. Depreciable land improvements prove that a fairly substantial portion of what we call “non-depreciable land” is really **depreciable** as land improvements. In effect, allocations toward depreciable land improvements reduce the amount allocated to non-depreciable land. All of this means more depreciation deductions and more savings. Land improvements are generally “Section 1250” property (the “1250” being the internal revenue code section, 1250).

**Goldmine Form To Use:** FORM 2 in Forms Appendix in the SAP’s - Componentizing Schedule of 15-Year Land Improvements.

3. **Building:** Depreciated over 27-1/2 for residential rental property or 39 years for non-residential (commercial) realty, straight-line method only. The building is the real property portion other than 5-year personal property, 15-year land improvements and the non-depreciable land portion. The building real property portion is “Section 1250” property (the “1250” being the internal revenue code section, 1250).

**Goldmine Form To Use:** FORM 3 in Forms Appendix in the SAP’s - Computation of Building Portion Based on Improvement Ratio.

4. **Land:** Last with a low (or no) value - no depreciation deductions. The last component in this allocation is the non-depreciable land. Do this with a low (or no) value. Componentizing the depreciable components first is a way to arrive a lower, leftover (“residual”) land value.
Goldmine Form To Use: FORM 5 in Forms Appendix in the SAP’s - Summary Allocation of Initial Cost Basis\Land Residual on the Renaissance.

Componentizing Preview: Below is a preview of componentizing depreciation for that same $100,000 property. Notice how much higher the $6,130 deduction is than the $2,800 from the previous Pistol Pete example.

**FINAL SUMMARY ALLOCATION OF INITIAL COST BASIS AND DEPRECIATION -$100,000 PROPERTY**

<table>
<thead>
<tr>
<th>A Property Component</th>
<th>B Total Allocated Basis</th>
<th>C % of Total</th>
<th>D Depreciation (First year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 5-year Personal Property</td>
<td>+ $15,900</td>
<td>15.9%</td>
<td>$3,180</td>
</tr>
<tr>
<td>2. 15-year Land Improves.</td>
<td>+ 10,200</td>
<td>10.2%</td>
<td>510</td>
</tr>
<tr>
<td>3. Building</td>
<td>+ 70,000</td>
<td>70.0</td>
<td>2,440</td>
</tr>
<tr>
<td>=3A. Sub Total (1 + 2 + 3)</td>
<td>= 96,100</td>
<td>96.1</td>
<td></td>
</tr>
<tr>
<td>4. Land – residual (5 – 3A) =</td>
<td>+ 3,900</td>
<td>3.9%</td>
<td>0</td>
</tr>
<tr>
<td>5. = Totals .</td>
<td>= $100,000</td>
<td>100%</td>
<td>$6,130</td>
</tr>
</tbody>
</table>

The above will be shown again in the next chapter with the supporting Goldmine Renaissance componentizing forms.

5. Check out land improvements that pertain to the building - Drains & pipes to and from the building, grading under the building, outside lighting for the building and utility connections to the building. They are depreciated over the recovery period of the building (27-1/2 yrs. residential rental or 39 yrs. non-residential), as opposed to just being non-depreciable land. So there is a tax benefit. But for smaller properties, allocating the cost to building land improvements may not always be practical or even worth it. But use your own judgment. I have students who do it.
Goldmine Form To Use: FORM 4 in Forms Appendix in the SAP’s - Schedule of Land Improvements Directly Associated To The Building {27-1/2 or 39 year write-off}.

6. Further allocations for more deductions from retired/replaced components - You also can further segment the above depreciable components via cost-segregation analysis. Such further allocations will enable you to fully deduct in one year components that are removed (usually for replacement), creating substantial deductions and savings. For a further discussion see Ch. 12-C.

**ALERT**: While you should still use them; tax software programs (such as Turbo-Tax) do not do componentizing, especially the Multi-Component Land Residual Method.

**D. DON’T CONFUSE COMPONENTIZING WITH “COMPONENT-DEPRECIATION”**

First let’s eliminate some confusion about componentizing (Cost Segregation Analysis). When you mention “componentizing”, some people (including tax practitioners) will say “Component depreciation is no longer allowed.” Technically they are right, but they misunderstand what we are doing here. While there may not be any more component depreciation, there is still componentizing. What’s the difference?

Before 1981, we did not have objective statutory recovery periods as we do now where you must use 5, 15, 27-1/2, 39, years (etc.), regardless of the age or condition of the property. Before 1981, we used “estimated useful lives”
which were based on judgmental, subjective factors such as the age, construction-type, condition and location of the property.

Thus, a building may have had a useful life of 25 to 50 years depending on these factors. Back then, component depreciation was a method that was used to increase depreciation deductions by componentizing (or breaking down) a building into its real structural components and then depreciating each structural component with a lower useful life.

For example, a building shell may have an estimated useful life of 35 years. But its allocated components may have a lower useful life as follows: Electrical - 10 years; plumbing - 12 years; roof - 20 years; heater - 15 years, etc. By depreciating each building component over each one’s lower useful life, you were reaping larger depreciation deductions.

Under today’s *Modified Accelerated Cost Recovery System* ("MACRS"), we do not use estimated, arbitrary useful lives. Instead we use the preset statutory recovery periods of 5, 15, 27-1/2, 39 years. Consequently, we cannot use “component depreciation” with different useful lives as per the above. However, provided we use these required recovery periods, we still can componentize to attain substantial tax savings using the *Multi-Component/ Land Residual Method*.

Reference Source (return tab): SAP 6, Part A

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in
any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
12-A
How To Value The Components

Reference Source (return tab): SAP 6, Part A-1

In this chapter on componentizing we will cover...

A. HOW TO VALUE THE COMPONENTS - SOURCES OF COST VALUATION

B. SUPPORT THE COMPONENTIZING ALLOCATIONS BY INSERTING THE BASIS VALUATIONS IN THE PURCHASE AGREEMENT AND HUD1 FORM

C. LOW VALUATION TOWARD LAND - SUPPORTING FACTORS

C-1. COMPARABLE LAND SALES ARE NOT NECESSARILY INDICATIVE OF THE ALLOCATED LAND VALUE AS THEY COULD ARTIFICIALLY INFLATE LAND VALUES

D. VALUATION OF COMPONENTS IS NOT AN EXACT SCIENCE

E. THERE IS NO LAW THAT SAYS YOU MUST HIRE A PROFESSIONAL FOR COMPONENTIZING

F. BYPASSING ANY PENALTY FOR OVERVALUATION OF COMPONENT ALLOCATIONS

A. HOW TO VALUE THE COMPONENTS - SOURCES OF COST VALUATION

1. Use your own estimates with the sources below and value each item according to its present condition. Self-valuation is allowed, Offshore Operations Trust, TC Memo; 1972-212. The value used should be their present
market retail value, reduced by an allowance for age and condition. Below are sources of do-it-yourself valuations by major property components.

<table>
<thead>
<tr>
<th>Property Component</th>
<th>Sources of Do-It-Yourself Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PERSONAL PROPERTY:</strong></td>
<td></td>
</tr>
<tr>
<td>Appliances, kitchen equipment,</td>
<td>Supplier’s catalog or web site such as</td>
</tr>
<tr>
<td>fixtures..............................</td>
<td>from Sears, Home Depot, Lowes.</td>
</tr>
<tr>
<td></td>
<td><strong><a href="http://www.sears.com">www.sears.com</a>; <a href="http://www.homedepot.com">www.homedepot.com</a>;</strong></td>
</tr>
<tr>
<td></td>
<td><strong><a href="http://www.lowes.com">www.lowes.com</a>;</strong></td>
</tr>
<tr>
<td>Furniture &amp; fixtures...................</td>
<td>Catalog or web site from furniture stores.</td>
</tr>
<tr>
<td>Other personal property</td>
<td>Construction costs books. Opinion of building</td>
</tr>
<tr>
<td></td>
<td>Contractors; get it on their letterheads.</td>
</tr>
<tr>
<td><strong>LAND IMPROVEMENTS:</strong></td>
<td></td>
</tr>
<tr>
<td>Landscaping and shrubbery............</td>
<td>On letterhead of landscaper or nursery.</td>
</tr>
<tr>
<td>Sidewalks, roads, pavements,</td>
<td>On letterhead of cement contractor or builder.</td>
</tr>
<tr>
<td>parking lots, curbs...................</td>
<td></td>
</tr>
<tr>
<td>Other land improvements...............</td>
<td>On letterhead of company that installs them.</td>
</tr>
<tr>
<td>All land improvements................</td>
<td>Supplier’s catalog or web site on such items.</td>
</tr>
<tr>
<td></td>
<td>Construction costs books.</td>
</tr>
<tr>
<td><strong>BUILDING:</strong></td>
<td>Building improvement ratio.</td>
</tr>
</tbody>
</table>

2. **Cost books.** One can determine the cost of the components from professional appraisal books, such as *Marshall & Swift’s*. Construction costs books are used by contractors, architects or appraisers. The *American Institute of Architects* and *Appraisal Institute* publish books on cost allocations, such as *Marshall & Swift’s*. See in this section for sources of valuation including web sites.
3. **Purchase agreement allocations.** Although not required, inserting the component allocations in the purchase agreement (and/or HUD 1 form) could support the component basis valuations. See part B of this chapter.

4. **The best is building contractors.** One of your most important sources for componentizing will be building contractors. They could be your most effective and least costly resource. When obtaining the opinion of contractors, get it in writing on their letterheads. This could be done at no charge while they are submitting estimates on work to be performed. For example a plumbing contractor could easily determine the value of the heater. A general contractor could do the same for almost any component. The same for a landscaper or cement contractors for land improvement valuations. Most contractors submit bids at no charge or for a small fee.

**SOURCES OF COST VALUATION**

The *American Institute of Architects* (AIA) and *Appraisal Institute* publish books on cost allocations. (AIA 1-800-242-3837, ext. 4 or 1-202-626-7300; *Appraisal Institute* 1-312-335-4100.

### Valuation Services

<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><a href="http://www.rsmeans.com">www.rsmeans.com</a></td>
<td><a href="http://www.marshallswift.com">www.marshallswift.com</a></td>
</tr>
<tr>
<td>Phone 1-800- 334-3509</td>
<td>1-800- 544-2678 Sales and Service</td>
</tr>
<tr>
<td>Fax 1-800- 632-6732</td>
<td>1-800- 526-2756 Technical Support</td>
</tr>
<tr>
<td></td>
<td>1- 213-683-9043 Customer Svc Fax</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Craftsman Book Company</th>
<th>Boeckh Building Valuation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Phone 1-800-829-8123</td>
<td></td>
</tr>
<tr>
<td>Fax 1-760-438-0398</td>
<td></td>
</tr>
</tbody>
</table>
B. SUPPORT THE COMPONENTIZING ALLOCATIONS BY INSERTING THE BASIS VALUATIONS IN THE PURCHASE AGREEMENT AND HUD1 FORM

A. Although not required, inserting the component allocations in the purchase agreement (and/or HUD 1 form) could support the component basis valuations.

B. Do so provided that it does not upset the transaction. That is there are no objections from the lender, seller, title company, attorneys, CPA’s or other concerned parties.

C. With this there is the following further discussion:

1. **It is not a guarantee that IRS will accept the stated allocations.** Putting the allocations in the purchase agreement could help to support allocations, especially if there are arm’s length negotiations between seller and buyer who are unrelated parties and have opposing interests.

   (a) **Supporting tax law cites where allocations have been accepted** - In *John B. Resell*, [TC Memo 1971-40], it was determined that the agreement between buyer and seller was based on business or economic reality. In another case, because the allocations made a difference between buyer and seller (i.e. they had opposed interests), the court accepted the stated allocations, *Gazette Telegraph Co.*, 209 F2d 926.

   (b) **No guarantee that allocations in contracts will hold up per tax law cites** - In *DC Lumber Corp.*, 1949, 12 TC 348(A), the court determined that the apportionment figures stated in the contract are not necessarily determinative of costs of the various assets purchases. In *Dryborough*, [(1966) 45 TC 424 (a)] the court stated that the IRS is free to disregard the value stated in the contract in order to prevent tax avoidance. Therefore, the courts will generally reject purchase agreement allocations if there are
artificial and unrealistic values and/or the allocations make little or no difference to buyer or seller.

(c) Scenarios in which allocations make little or no difference to buyer or seller are:

1. For the buyer: (a) Acquisition of the property for sale to customers in the ordinary course of business as a dealer, (b) Acquisition for purpose of demolition and (c) Acquisition as a personal-use residence. In these situations, depreciation deductions are not permitted.

2. For the seller: (a) sale of a principal residence or vacation home, (b) sale of property held for sale to customers in the ordinary course of business (dealer property), (c) sale of land or any other property where no depreciation has been allowed or allowable.

In the above type situations, there is an excellent chance that the courts will reject any stated allocations because the buyer and seller do not have opposing interests.

(d) But purchase/sales agreement allocations could impress IRS examination agents - What happens at the court level and the IRS audit level are often different. Even without opposing interests, stating allocations in the agreement may very well impress an IRS agent. (With IRS agents, the name of the game is recordkeeping & documentation.) Stated allocations in the sales/purchase agreement may be the right documentation.

(e) Do it! So it boils down to this - regardless if the interests of buyer and seller are opposed or not, put the allocations in the purchase agreement anyway, provided it does not upset (or “kill”) a good deal! Otherwise you have everything to gain, nothing to lose.
2. Tangible property allocations are not required by tax law to be in the purchase agreement

(a) **No clear-cut tax law** - Although practitioners (especially attorneys) will say such agreement allocations are required, there is no specific and clear-cut tax provision that states you must include these types of tangible real property allocations in the agreement in order for the allocations to hold up. This is supported by the previously cited cases where the court threw out the allocations.

(b) **When buyer and seller have opposing interests** - These allocations generally become hot issues between the buyer and seller with larger complexes (especially hotels & motels) where there is a significant amount of personal property which qualifies for larger depreciation deductions for the buyer, but ordinary income recapture for the seller. It is especially in these latter situations that tax or legal advisors insist that the allocations be stated in the purchase agreement. Consequently, the seller and buyer, who have opposing interests, cannot agree and the deal unnecessarily goes down the drain.

(c) **Leave allocations out of agreement and let the buyer and seller do their own separate allocations** - Again, I believe that even though not required by tax law, such allocations could be in the purchase agreement. However, if these stated allocations are going to upset the transaction, then forget about them and leave them out of the agreement. So then what do the buyer and seller do? Let them do their own allocations, however different. If they happen to both be audited on the same issue and at the same time *, the party who best supports their allocations will prevail. In this very unlikely event*, the other party will have to abide by the prevailing party’s allocations.
(d) IRS outcome – The chances of both parties being audited on the same issue, at the same time and at the same IRS office are next to none, at best!

3. Purchase/sale of intangible business assets require an allocation. In the purchase/sale of a business, which would include inventory, and intangible assets such as goodwill, covenant-not-to-compete, license, etc., then allocations need to be disclosed in the purchase/sales agreement, IRC 1060.

4. MONEY-SAVING TIP: Inserting the allocation of personal property on the HUD-1 settlement sheet may also save on property taxes and/or transfer taxes in certain locales. Check the laws of the property’s local or state.

C. LOW VALUATION TOWARD LAND - SUPPORTING FACTORS

1. Allocation of depreciable components first, land last. By componentizing and allocating the depreciable components (in the previous modules) first, and land last, is a way to arrive at the leftover (“residual”) land value.

2. Land improvement allocations - Allocations toward depreciable land improvements reduce the amount allocated to non-depreciable land.

3. Use higher building valuation. Use the building basis valuation method that gives you a higher building value and lower land value, yet without taking away from the allocations to personal property and 15-year land improvements associated with the land. The building improvement ratio method proved to be very effective for accomplishing this.

4. Special valuation factors (such as highest & best use) - In Platt (75-1 USTC) a low allocation to land was upheld where it was indicated that the highest & best use of the property was for residential purposes even though it was zoned for industrial use. The rental property was in an area where
there was a housing shortage. Such a housing shortage would make houses (i.e. buildings) more valuable, land less valuable. This is consistent with the aforementioned arguments supporting large building allocations.

5. Condominiums* – With condominiums the owner does not have a direct fee simple interest in the common elements which include land. Accordingly there is a lower-than-usual land value, even zero.

*CALBERT AIELLO IRS STORY OF NO LAND VALUE
Back then when I was in tax practice, I was asked by a new client to represent them on an extensive IRS field audit (this is where the IRS agent comes to the taxpayer’s or CPA’s office to do the audit). On the tax return being audited there were two beachfront rental condominiums where no land value was allocated at all by the tax practitioner who prepared the return (who was not me). I used this very argument -- condo ownership = little land value. I supported this argument by the condo documentation which indicated very low allocations toward the common elements (which includes land). LO & behold, the IRS field agent (who was no dummy!) accepted my argument > no land value. Yes, no land value, despite being a property at the New Jersey seashore where land values are generally considered higher than usual. This is especially so of beachfront property. Many successful cases are the result of such new logical arguments. New precedents are always being set.

6. Generally do not use comparable sales, see part C next.

C-1. COMPARABLE LAND SALES ARE NOT NECESSARILY INDICATIVE OF THE ALLOCATED LAND VALUE AS THEY COULD ARTIFICIALLY INFLATE LAND VALUES

1. Using comparable sales. Another method used to determine such allocations toward land is "comparable sales". Here, you value the land portion of a property based on what adjacent or nearby vacant lots have
recently sold for. This method is frequently used for investment properties in high-priced resort areas.

2. Problem with using comparable sales = high distorted land value with the loss of depreciation deductions. The problem with this method is that it often provides a very high (and distorted) land value, which is obviously unfavorable to the investor. For example, you buy a resort-area property for $1,000,000. A nearby lot has sold for $600,000. Under this method your allocation toward land is $600,000 or a whopping 60% of the total cost of $1,000,000. (I say no way!). The higher the land value the less toward the other depreciable components, less deductions = less savings.

3. No one method is necessarily the right one. This is supported in Est. Nail (1972) 59 TC 187 (A). Here, the court concluded that use of comparative sales is not an exclusive method of valuation and may have to be considered in conjunction with other methods, such as capitalization of income. The appellate court in Douglas Hotel Co. V. Comm'r supports this by stating comparative sales is, of course, not the only evidence which may be considered.

4. Comparable sales have been considered not totally reliable for the following reasons:

   (a) Where there was an absence of truly comparable properties within a reasonable time surrounding the valuation date, Andrews (1930, CA 2) 38 F2d 55(e); Jacobs, (1930) 20 BTA 529 (i).

   Comment: There must at least be a reasonable degree of comparability between properties.

   (b) Where there is a sudden boom in land values, Wilson (1926) 5 BTA 615 (A) (e).
Comment: In this situation, many times properties quickly become artificially inflated because of speculation or euphoric optimism. Such a quick and sudden increase could cause a distortion in fair market value.

(c) **Where the sales price of the property was not indicative of fair market value.** For example the property may have been bought or sold under compulsion or distress giving either the seller or to the buyer an opportunity to exploit an unusual situation, *Ireland*, TC Memo 5/8/51.

Comment: For example, an overly anxious and emotional buyer will pay more than fair market value.

(d) **Where the sales price is inflated because the terms of the sale were liberal,** such as little or no money down, or a low interest rate as part of "creative financing", *Kaplan vs. U.S.* (1967), DC Ariz. (279F Supp 709).

5. **Such comparable land sales can distort a property’s total valuation; more value is in the building.** For the reasons previously discussed in module 8 much of the property value should be in the building. Once a building is placed on land, then the *overall valuation* picture changes with more value toward the building.

Also, a substantial portion of what we call “non-depreciable land” is really *depreciable* as land improvements. In effect, allocations toward these depreciable land improvements reduce the amount allocated to non-depreciable land.

**D. VALUATION OF COMPONENTS IS NOT AN EXACT SCIENCE**

1. **An estimate; appraisal not required.** There seems to be a misconception that the valuation of the different components must be exact for
componentizing to qualify. One can determine the cost of the components from professional appraisal books, such as *Marshall & Swift’s* or contact an appraiser. However, it is not required that you do either. Independent appraisal may have its place for larger projects. But it may be too expensive for many real estate investors. Moreover, while independent appraisal can be permitted (*Pittsburg Plate Glass Co.* TCM 1965-159), it has been disallowed if it is determined that the appraiser is not qualified, *Meeker*, TC Memo, 1981-215. The IRS is no authority either. In a number of cases on valuation the courts have either disregarded the IRS’s expert testimony, or refused to let an IRS employee to testify at all, because they had little or no familiarity with local real estate market conditions, *Garstin vs. US*, 1965, CtCl, 352 F2d, 537 (I); *Brown*, TC Memo 1966-92(g); *Knoell, Exr. vs. US*, 1964, DC, Pa., 236 F Supp 299(e).

2. **Valuation is quite arbitrary.** The “value” of an item is also not always clear. In his book, *Contesting IRS Penalties*, IRS expert, Holmes F. Couch agrees. He states that the general IRS viewpoint on such valuation issues is that it is very controversial and therefore very difficult to dispute because there is much comparative analysis involved. Thus, there is a much wider tolerance for error. In fact, there is the following statement from an IRS training manual titled, *IRS Valuation Training For Appeals Officers*, Coursebook # 6126-002, “As appeals officers, we should always strive to settle cases. This is especially true with respect to valuation cases because of the judicial distaste for such issues.” (Underlined emphasis added). In one case, the tax court stated that ....”We are convinced that the valuation issue is capable of resolution by the parties themselves, thereby saving the expenditure of time, effort and money by the parties and the Court -- a process not likely to produce a better result”, *Buffalo Tool & Die*, 74TC 441 (1980). Self appraisal, based on experience, has held up, *Offshore Operations Trust*, TC Memo; 1972-212. Based on the above, here is how I
interpret the above -- *You can go ahead and value each component on your own, making reasonable estimates.*

3. **Overvaluation penalty but much leeway.** Under Internal Revenue Code Section 6662(a), there is a penalty for overvaluation. But this provision gives you so much leeway that even if you deliberately tried to incur the penalty, you probably still could not do it. (For more info about the penalty, see part F of this chapter)

**E. THERE IS NO LAW THAT SAYS YOU MUST HIRE A PROFESSIONAL FOR COMPONENTIZING**

There are so-called professionals (typically known as cost segregation consultants or engineers) who will do the componentizing for you.

**ALERT:** Their fees are high (often based on projected savings) and they will only do it for larger properties. They will tell you it is not worth on smaller properties. How wrong they are! I started over 25 years ago with $20,000 properties and it was worth it then. This is especially so when you do it yourself using this course.

**Not required.** Independent appraisal may have its place for larger projects. However it may be too expensive for many real estate investors (although not necessarily for commercial investors). Moreover, while independent appraisal can be permitted (*Pittsburg Plate Glass Co*. TCM 1965-159), it has been disallowed if it is determined that the appraiser is not qualified, *Meeker*, TC Memo, 1981-215. The IRS is no authority either. In a number of cases on valuation the courts have either disregarded the IRS’s expert testimony, or refused to let an IRS employee to testify at all, because they had little or no familiarity with local real estate market conditions, *Garstin vs. US*, 1965,
CtCl, 352 F2d, 537 (I); Brown, TC Memo 1966-92(g); Knoell, Exr. vs. US, 1964, DC, Pa., 236 F Supp 299(e).

The IRS, in the Cost Segregation Audit Techniques Guide (ATG), states that the preparation of a cost segregation study requires knowledge of both construction process and tax law. However, the IRS acknowledges in the ATG that there are currently no prescribed qualifications for the cost segregation practitioner. Moreover, the ATG was developed by a cross-functional team of Service engineers and agents and is not intended as an official IRS pronouncement. Accordingly, it may not be cited as authority. This essentially means that any fairly knowledgeable real estate investor can do it, especially with this course.

**What-To-Do:** Use the do-it-yourself techniques of this program. You could also hire a Certified Bookkeeper to put the componentizing forms on QuickBooks. To find a Certified Bookkeeper (CB) who knows QuickBooks, contact below...

**AMERICAN INSTITUTE OF PROFESSIONAL BOOKKEEPERS (AIPB)**
1-800-622-0121 PH; 1-800-541-0066 F; info@aipb.org www.aipb.org/

**When you may consider hiring a professional – larger properties.** Because of the huge deductions and substantial tax savings with larger commercial property, it may pay the commercial investor to hire an experienced cost segregation consultant or engineering professional to help with the component breakdown, but still using this course. However, beware of “new kids on the block” who are jumping on the componentizing bandwagon which is just starting to get popular (it’s only been around for over 40 years). When hiring a professional carefully check their experience and credentials. Get their fees in writing, upfront. Or even better contact us for a referral at taxbible@aol.com with your Renaissance VIP code.
F. BYPASSING ANY PENALTY FOR OVERVALUATION OF COMPONENT ALLOCATIONS

If you overvalue a property component, the IRS may impose a penalty of 20% of the portion of any underpayment of tax from a “substantial valuation overstatement”, IRC 6662(a). However, the law gives you a lot of leeway. For the penalty to apply the value of the property must be 200% (double) or more than the amount determined to be the correct amount, IRC 6662(e)(1). Moreover, the overvaluation must also result in a substantial misstatement of taxes exceeding $5,000 ($10,000 in the case of a C-corp), IRC 6662(e)(2). Even further, the IRS may waive the penalty if you can show reasonable cause and you acted in good faith, IRC 6664(c)(1).

TAX BREAK: Because the law gives you a significant amount of leeway, it is highly unlikely that you will incur any penalty. This is especially so if you follow the instructions for using the Multi-Component/Land-Residual Method beginning with Chapter 12.

Reference Source (return tab): SAP 6, Part A-1

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
IRS Tax Reporting For Depreciation and Componentizing

Reference Source (return tab): SAP 6, Part B

In this chapter on componentizing we will cover...

A. IRS FORM 4562 – A SUPPORTING SCHEDULE FOR ALL FORMS OF OWNERSHIP

B. PERSONAL PROPERTY - DEPRECIATION

C. LAND IMRPLOVEMENTS - DEPRECIATION

D. REAL PROPERTY (BUILDING) - DEPRECIATION

E. FINAL SUMMARY ALLOCATION OF INITIAL COST BASIS AND DEPRECIATION

F. RETIRED COMPONENTS – IRS FORM 4797

A. IRS FORM 4562 – A SUPPORTING SCHEDULE FOR ALL FORMS OF OWNERSHIP

IRS Form 4562 is where depreciation deductions are reported. It is a supporting schedule to all forms of ownership:

_ Individual Schedule E
_ Partnership 1065*
_ LLC-partnership 1065*
_ S-corporation 1120S
_ C-corporation 1120.
(*Form 1065 is the most recommended form for real estate ownership because it has superior tax advantages for real estate as opposed to Schedule E and corporations).

**Below is a repeat of the Summary Allocation of Initial Cost Basis/Land Residual from Chapter 12-A with the components.**

Investor name: **Diversified Property Associates (DPA), LLC**
Date purchased: **1/1/00**  Date placed in service: **1/1/00**
Property type: **Duplex (2 units)**
Property address: **121 Mantua St., Philadelphia, PA. 19148**

<table>
<thead>
<tr>
<th>A Property Component</th>
<th>B Total Allocated Basis</th>
<th>C % of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 5-year Personal Property</td>
<td>+ $15,900</td>
<td>15.9%</td>
</tr>
<tr>
<td>2. 15-year Land Improves.</td>
<td>+ 10,200</td>
<td>10.2%</td>
</tr>
<tr>
<td>3. Building</td>
<td>+ 70,000</td>
<td>70.0%</td>
</tr>
<tr>
<td>=3A. Sub Total (1 + 2 + 3)</td>
<td>= 96,100</td>
<td>96.1%</td>
</tr>
<tr>
<td>4. Land – residual (5 – 3A)</td>
<td>= 3,900</td>
<td>3.9%</td>
</tr>
<tr>
<td>5. = Totals</td>
<td>= $100,000</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Depreciation computation for each component.** Below is the depreciation computation for each of the above components followed by the summary allocation (filled-in version) of each component with depreciation.

**B. PERSONAL PROPERTY - DEPRECIATION**

The depreciation computation below is shown for the entire 6 years, followed by IRS depreciation form 4562. An automatic one-half year of depreciation is allowed in the first year of operation, regardless of when property is placed in service. This is why the 5-year personal property depreciation table below overlaps into 6 years.
# DEPRECIATION COMPUTATION FORM – PERSONAL PROPERTY - INITIAL PROPERTY ACQUISITION

(Filled-in for internal use only)

## Table

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Year</td>
<td>Total of Basis Personal Property (line 4 above)</td>
<td>Less Amount of Retired of PP items</td>
<td>Net Amount of PP Basis for Depreciation (col B less col C)</td>
<td>Annual Percentage Rate (Accelerated)</td>
<td>Annual Depreciation Deduction (col D X col E)</td>
</tr>
<tr>
<td>1</td>
<td>$15,900</td>
<td>-$0</td>
<td>=$15,900</td>
<td>20.00 %</td>
<td>=$3180</td>
</tr>
<tr>
<td>2</td>
<td>$15,900</td>
<td>-$0</td>
<td>=$15,900</td>
<td>32.00 %</td>
<td>=5,088</td>
</tr>
<tr>
<td>3</td>
<td>$15,900</td>
<td>-$0</td>
<td>=$15,900</td>
<td>19.20 %</td>
<td>=3,053</td>
</tr>
<tr>
<td>4</td>
<td>$15,900</td>
<td>-$0</td>
<td>=$15,900</td>
<td>11.52 %</td>
<td>=1,832</td>
</tr>
<tr>
<td>5</td>
<td>$15,900</td>
<td>-$0</td>
<td>=$15,900</td>
<td>11.52 %</td>
<td>=1,832</td>
</tr>
<tr>
<td>6</td>
<td>$15,900</td>
<td>-$0</td>
<td>=$15,900</td>
<td>5.76 %</td>
<td>=915</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>$15,900</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

## IRS Form 4562 – Depreciation for first year (Initial Purchase of 5-yr. PP)

<table>
<thead>
<tr>
<th>Part III MACRS Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section B – Assets Placed in Service During Tax Year...</strong></td>
</tr>
<tr>
<td>(a) Classification of Property (b) Month /year placed in service (C) Basis for depreciation (d) Recovery period (e) Convention (f) Method (g) Depreciation Deduction</td>
</tr>
<tr>
<td>19b 5-year property</td>
</tr>
</tbody>
</table>

(The second and remaining years’ depreciation of all property components goes on line 17 of form 4562).

### Later acquisitions – separate depreciation schedule.

Later acquisitions of personal property are to use a separate depreciation schedule – IRS form 4562.

## C. LAND IMPROVEMENTS - DEPRECIATION

The depreciation computation below is shown for the first 2 years, followed by the entire 15-year table and IRS depreciation form 4562. An automatic one-half
year of depreciation is allowed in the first year of operation, regardless of when property is placed in service. This is why the 15-year land improvement depreciation table below overlaps into 16 years.

**DEPRECIATION COMPUTATION FORM – LAND IMPROVEMENTS - INITIAL PROPERTY ACQUISITION**

(Filled-in for internal use only)

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
<th>E</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Year</strong></td>
<td><strong>Total Basis of LI (line 3 above)</strong></td>
<td><strong>Less Any Amount Retired of LI items replaced</strong></td>
<td><strong>Net Amount of LI Basis for Depreciation (col B less col C)</strong></td>
<td><strong>Annual Percentage Rate (Accelerated)</strong></td>
<td><strong>Annual Depreciation Deduction (col D X col E)</strong></td>
</tr>
<tr>
<td>1</td>
<td>$10,200</td>
<td>-$0</td>
<td>$10,200</td>
<td>5.00%</td>
<td>$510</td>
</tr>
<tr>
<td>2</td>
<td>$10,200</td>
<td>-$0</td>
<td>$10,200</td>
<td>9.50</td>
<td>$969</td>
</tr>
</tbody>
</table>

**DEPRECIATION TABLE 15-YEAR LAND IMPROVEMENTS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual %</th>
<th>Year</th>
<th>Annual %</th>
<th>Year</th>
<th>Annual %</th>
<th>Year</th>
<th>Annual %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5.00%</td>
<td>5</td>
<td>6.93</td>
<td>9</td>
<td>5.91</td>
<td>13</td>
<td>5.91</td>
</tr>
<tr>
<td>2</td>
<td>9.50</td>
<td>6</td>
<td>6.23</td>
<td>10</td>
<td>5.90</td>
<td>14</td>
<td>5.90</td>
</tr>
<tr>
<td>3</td>
<td>8.55</td>
<td>7</td>
<td>5.90</td>
<td>11</td>
<td>5.91</td>
<td>15</td>
<td>5.91</td>
</tr>
<tr>
<td>4</td>
<td>7.70</td>
<td>8</td>
<td>5.90</td>
<td>12</td>
<td>5.90</td>
<td>16</td>
<td>2.95</td>
</tr>
</tbody>
</table>

**IRS Form 4562 – Depreciation for first year** (Initial Purchase of 15-yr. LI)

<table>
<thead>
<tr>
<th>Part III MACRS Depreciation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Section B – Assets Placed in Service During Tax Year...</strong></td>
</tr>
<tr>
<td><strong>(a) Classification of Property</strong></td>
</tr>
<tr>
<td>19e 15-year property</td>
</tr>
</tbody>
</table>

Later acquisitions – separate depreciation schedule. Later acquisitions of 15-year land improvements are to use a separate depreciation schedule – IRS form 4562.

**D. REAL PROPERTY (BUILDING) - DEPRECIATION**

Below are the depreciation tables for the real property (building).
The depreciation computations below are shown for the first 2 years.

**IRS DEPRECIATION MACRS TABLES FOR REAL PROPERTY (BUILDING)**

### Table 1 -- Residential Rental Property

Residential Rental Property (Building and Building Land Improvements) - 27-1/2 Years (Straight-line) -- For Property Placed In Service From January 1, 1987 To The Present

<table>
<thead>
<tr>
<th>Month property placed in service</th>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>3.485</td>
<td>3.182</td>
<td>2.879</td>
<td>2.576</td>
<td>2.273</td>
<td>1.970</td>
<td>1.667</td>
<td>1.364</td>
<td>1.061</td>
<td>0.758</td>
<td>0.455</td>
<td>0.152</td>
</tr>
<tr>
<td>29</td>
<td></td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.152</td>
<td>0.455</td>
<td>0.758</td>
<td>1.061</td>
<td>1.364</td>
<td>1.667</td>
<td></td>
</tr>
</tbody>
</table>

**NOTE:** The above are percentages. For example, a property is acquired on January 1 and $100,000 is allocated to the building. The depreciation for the first year is $3485 ($100,000 x 3.485%). The depreciation for the second year is $3636 ($100,000 x 3.636%).

### Table 2 -- Non-Residential Real Property

Non-Residential Real Property (Building and Building Land Improvements) - 39 Years (Straight-line) -- For Property Placed In Service From May 13, 1993 To The Present

<table>
<thead>
<tr>
<th>Month property placed in service</th>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>2</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.000</td>
<td>0.152</td>
<td>0.455</td>
<td>0.758</td>
<td>1.061</td>
<td>1.364</td>
<td>1.667</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

5
Partial years. For partial years (such as the first and last years) the amount of the depreciation is prorated according to the number of months placed in service as per IRS tables.

IRS Form. Building depreciation is reported to IRS on form 4562, Part III, line 19h for Residential Rental Property and line 19i for Nonresidential Real Property for the first year. The applicable form 4562 excerpt (blank format) is below:

<table>
<thead>
<tr>
<th>Part III MACRS Depreciation</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Classification of Property*</td>
<td>(b) Month/year placed in service</td>
<td>(C) Basis for depreciation</td>
<td>(d) Recovery period</td>
<td>(e) Convention</td>
<td>(f) Method</td>
<td>(g) Depreciation Deduction</td>
</tr>
<tr>
<td>19h Residential Rental Property</td>
<td>Jan., 00</td>
<td>$ 70,000</td>
<td>27.5 yrs.</td>
<td>MM</td>
<td>SL</td>
<td>$2,440*</td>
</tr>
</tbody>
</table>

For subsequent years put the total of all depreciation (building and other components) lumped together on or around line 17 on form 4562.

IRS Form 4562: Filled-In Format – Residential Property Placed in Service – Jan. of 1st Year

<table>
<thead>
<tr>
<th>Part III MACRS Depreciation</th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Classification of Property*</td>
<td>(b) Month/year placed in service</td>
<td>(C) Basis for depreciation</td>
<td>(d) Recovery period</td>
<td>(e) Convention</td>
<td>(f) Method</td>
<td>(g) Depreciation Deduction</td>
</tr>
<tr>
<td>19h Residential Rental Property</td>
<td>Jan., 00</td>
<td>$ 70,000</td>
<td>27.5 yrs.</td>
<td>MM</td>
<td>SL</td>
<td>$2,440*</td>
</tr>
</tbody>
</table>

(*$70,00 x 3.485 = $2240)
For subsequent years put the total of all depreciation (building and other components) on or around line 17 on form 4562. Here the second year depreciation would be $2,545 ($70,000 x 3.636) which would be included on line 17 as per the above.

Later acquisitions – separate depreciation schedule. Later acquisitions of real property, such as real property capital improvements are to use a separate depreciation schedule – IRS form 4562. However, many real property capital improvements may be reclassified into fully deductible repairs. See Chapter 18.

E. FINAL SUMMARY ALLOCATION OF INITIAL COST BASIS AND DEPRECIATION
(Filled-in format for internal use only)

Investor name: Diversified Property Associates (DPA), LLC
Date purchased: 1/1/00 Date placed in service: 1/1/00
Property type: Duplex (2 units)
Property address: 121 Mantua St., Philadelphia, PA. 19148

<table>
<thead>
<tr>
<th>A Property Component</th>
<th>B Total Allocated Basis</th>
<th>C % of Total</th>
<th>D Depreciation (First year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. 5-year Personal Property</td>
<td>+ $15,900</td>
<td>15.9%</td>
<td>$3,180</td>
</tr>
<tr>
<td>2. 15-year Land Improves.</td>
<td>+ 10,200</td>
<td>10.2%</td>
<td>510</td>
</tr>
<tr>
<td>3. Building</td>
<td>+ 70,000</td>
<td>70.0</td>
<td>2,440</td>
</tr>
<tr>
<td>=3A. Sub Total (1 + 2 + 3)</td>
<td>= 96,100</td>
<td>96.1</td>
<td></td>
</tr>
<tr>
<td>4. Land – residual (5 – 3A) =</td>
<td>+ 3,900</td>
<td>3.9%</td>
<td>0</td>
</tr>
<tr>
<td>5. = Totals .</td>
<td>= $100,000</td>
<td>100%</td>
<td>$6,130</td>
</tr>
</tbody>
</table>

F. RETIRED COMPONENTS – IRS FORM 4797

IRS Form 4797 is where the full loss deduction of retired/replaced components is reported. This is further discussed in Chapter 12-C.
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
In this chapter on componentizing we will cover...

A. DEDUCTING RETIRED PERSONAL PROPERTY OR LAND IMPROVEMENT COMPONENTS – ORDINARY LOSS

B. IRS TAX REPORTING OF THE FULL DEDUCTION OF RETIRED COMPONENT – EITHER UPON THE INITIAL ACQUISITION OF THE PROPERTY OR A LATER REPLACEMENT - IRS FORM 4797

C. FULL DEDUCTION FOR LATER RETIREMENTS AFTER INITIAL ACQUISITION – EXAMPLE WITH FILLED-IN FORM

D. SUPPORTING TAX LAW CITES FOR DEDUCTING RETIRED/ABANDONED COMPONENTS

E. MISCONCEPTION: REPLACED COMPONENTS HAVE NO VALUE

F. SEGMENTING THE BUILDING (REAL PROPERTY) INTO ITS STRUCTURAL COMPONENTS

A. DEDUCTING RETIRED PERSONAL PROPERTY OR LAND IMPROVEMENT COMPONENTS – ORDINARY LOSS

Both the componentizing schedules for personal property and 15-year land improvements have as the last column “Amount Retired”. This is for any allocated personal property or land improvement items that will be retired (or “gutted out” or removed) upon the initial acquisition of the property. The item will generally be replaced with a separately purchased item (but does not have
to be in order to get the retirement deduction. By initially doing the
segmentizing of each item of personal property or land improvement (using
these forms from the Renaissance Goldmine forms disk, you are setting up to
fully deduct (all in one year) the allocated basis of the retired item right when
you first acquire the property.

**Example.** You allocated $1,000 to carpeting on line number 31, but you will be
replacing it with new carpeting. Here is what line number 31 would look like:

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Cite</td>
<td>Personal Property Item w/Tax Cite Code</td>
<td>No of Units</td>
<td>Per Unit Value</td>
<td>Total Basis (col 4 x col 3)</td>
<td>Amount Retired</td>
</tr>
<tr>
<td>31</td>
<td>31. Carpeting (not glued down)</td>
<td>1</td>
<td>$1,000</td>
<td>$1,000</td>
<td><strong>$1,000</strong></td>
</tr>
</tbody>
</table>

The $1,000 amount retired (removed) is fully deducted as an ordinary loss on IRS
form 4797 (see later in this chapter).

**Misconception: Retired Components Have No Value** - This misconception
is that such a component should have no value and therefore no basis to write
off because you are removing it. Not true. See part E of this chapter for a
further discussion.

**Later retirements.** The remaining basis of any personal property item that is
later retired within the 5 years can also be fully deducted as per the above.
(The same for land improvements later retired within the 15 years can also
be fully deducted as per the above.) This, along with the tax reporting of
retired components, is discussed in part B of this chapter.

**Separate purchase.** You then depreciate the new replacement personal
property (carpeting) over 5 years. The new replacement personal property
will require a separate Depreciation Computation Form for the year of
acquisition with a separate IRS form 4562, and also may qualify for bonus
depreciation.
B. IRS TAX REPORTING OF THE FULL DEDUCTION OF RETIRED COMPONENT – EITHER UPON THE INITIAL ACQUISITION OF THE PROPERTY OR A LATER REPLACEMENT - IRS FORM 4797

Report the retirement as an ordinary loss on IRS form 4797 (Sale of Business Property) Part II, line 10. Such a retirement ordinary loss is not subject to passive loss limitations (PAL) and is not a preference item for purposes of alternative minimum tax (AMT).

IRS Form 4797 is where the full loss deduction of retired/replaced components is reported. It is a supporting schedule to all forms of ownership:

_Individual Schedule E
_Partnership 1065*
_LLCC-partnership 1065*
_S-corporation 1120S
_C-corporation 1120.

(*Form 1065 is the most recommended form for real estate ownership because it has superior tax advantages for real estate as opposed to Schedule E and corporations).

The applicable excerpt from IRS form 4797 is below for the above $1,000 personal property (carpeting) retirement (from part A of this chapter):

<table>
<thead>
<tr>
<th>4797</th>
<th>Sales of Business Property</th>
<th>20XX</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Part II Ordinary Gains and Losses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) Description of Property</td>
<td>(b) Date Acquired</td>
<td>(c) Date Sold</td>
</tr>
<tr>
<td>Section 1245 business asset</td>
<td>1/1/00</td>
<td>1/1/00</td>
</tr>
</tbody>
</table>
The above loss is ultimately carried over to IRS Form 1040 offsetting other 1040 income and reducing the tax liability (assuming you do not use a C-corporation as a primary RE entity, which you should not).

C. FULL DEDUCTION FOR LATER RETIREMENTS AFTER INITIAL ACQUISITION – EXAMPLE WITH FILLED-IN FORM

Land Improvement Example – Later retirement\replacement. When you first purchased the property you allocated $3,000 to the original sprinkler system (a 15-year land improvement) and claimed a total of $922 depreciation in the first four years, leaving an adjusted basis of $2,078. You replace the sprinkler system in the 5th year and therefore fully deduct the remaining basis of $2,078 as an ordinary non-cash deduction without limit.

Separate purchase. You then depreciate the new sprinkler system over 15 years (much quicker than the building). The new sprinkler system will require a separate Depreciation Computation Form for the year of acquisition with a separate IRS form 4562, and also may qualify for bonus depreciation.

2. IRS tax reporting of retired\replaced component – either upon the initial acquisition of the property or a later replacement: Report the retirement as an ordinary loss on IRS form 4797, Part II, line 10.

In the above example it would be the $2,078 remaining basis of the old sprinkler system.

Do the same tax reporting for any land improvement items that are retired with the initial acquisition of the property.

The applicable excerpt from IRS form 4797 is below, sample filled-in with the above example of a later land improvement retirement:
4797 | Sales of Business Property | 20XX

Part II Ordinary Gains and Losses

10. Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less)

<table>
<thead>
<tr>
<th>(a) Description of Property</th>
<th>(b) Date Acquired</th>
<th>(c) Date Sold</th>
<th>(d) Gross Sales Price</th>
<th>(e) Depreciation allowed or allowable</th>
<th>(f) Cost or other basis</th>
<th>(g) Gain or (loss) subtract (f) from sum of (d) and (e)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Section 1250 business asset</td>
<td>1/1/00</td>
<td>1/1/05</td>
<td>0</td>
<td>$922</td>
<td>$3,000</td>
<td>($2078)</td>
</tr>
</tbody>
</table>

D. SUPPORTING TAX LAW CITES FOR DEDUCTING RETIRED/ABANDONED COMPONENTS

IRS Regulation 1.167(a)-8, Retirements  - States the following:

Gains and losses on retirements. For the purpose of this section the term “retirement” means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefore, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be
recognized, the amount of such gain or loss, and the basis for determining gain or loss.

Where an asset is retired by sale at arm’s length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

Where an asset is returned by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use); loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale exchange, or other disposition.

IRS Publication 544 - States the following: The abandonment of property is a disposition of property. You abandon property when you voluntarily give up possession of the property with the intention of ending your ownership but without passing it on to anyone else. Loss from abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset. The loss is the amount of the property’s adjusted basis when abandoned. This rule also applies to leasehold improvements the lessor made for the lessee, that were abandoned. You may not deduct any loss from abandonment of your home or other property held for personal use.
The above makes it clear that the irrevocable retirement of a rental property component is abandonment and a fully deductible ordinary loss.

E. MISCONCEPTION: RETIRED COMPONENTS HAVE NO VALUE

This misconception is that such a component should have no value and therefore no basis to write off because you are removing it. Not true. First of all, when you purchased the property, you paid something for that component. So this unto itself supports some valuation.

A full blown discussion of appraisal valuation is beyond our scope. But according to the cost approach of appraisal valuation, the value of the component will be its current cost to reproduce or replace less depreciation (or loss in value) from physical deterioration, functional obsolescence and economic obsolescence. The opinion of depreciation (loss in value) is very subjective and, unlike tax depreciation, it does not follow any rigid mathematical or financial formula or rule. Again, the value of a component will be its current cost to reproduce or replace less depreciation ranging typically from 10% to 70%, depending largely on its present condition, age and functional use. Even older components could have a low effective age (its age as indicated by its condition). Moreover, just because a component is replaced does not mean it was in poor condition (such as a cabinet) or not working mechanically (such as a sprinkler system). For different reasons investors still will frequently want to replace the component. And even if it is in poor condition or not working, it still has some value based on the fact that you paid something for that component and the above cost approach of valuation.

F. SEGMENTING THE BUILDING (REAL PROPERTY) INTO ITS STRUCTURAL COMPONENTS
1. **Tax Benefit** - An early faster non-cash deduction of the retirement of real property components before 27-1/2 or 39 yrs -- A real property structural component may have to be retired because of, obsolescence, malfunction, or you just want to replace it (remove or gut out). In this case you may be able to fully deduct (all in one year) the remaining adjusted basis of the building component as an ordinary loss deduction on IRS Form 4797.

2. **Example of deducting existing components that are replaced:**
   When you first purchased the property, segmenting the building into its structural components, you allocated $6,400 to the original roof and depreciated it over 27-1/2 years straight-line claiming $233 depreciation (rounded) in the first 5 years (total $1165), leaving an adjusted basis of $5,235 ($6400 less 1165). You replace the roof in the sixth year and fully deduct the remaining basis of **$5,235** as an ordinary non-cash deduction in the sixth year of replacement. Under this premise you would do the same for the remaining basis of other segregated real property components that are retired - such as flooring, walls, plumbing, electrical, etc.

3. **Possible controversy.** Doing the above segmenting the building into its structural components may be subject to IRS controversy as there are conflicting opinions. While I believe there is support for doing it, and if you want to consider doing it, it is highly recommended that you do the following:

   1. Do it for larger properties (at least around $500,000).
   2. Use a cost segregation consultant, appraiser or other competent expert on componentizing, still using this publication and the form at the end of this chapter (*Schedule of Building Structural Components*). Email us for a referral with your VIP code.

   **An exception to consider not doing 1 or 2 above is new construction:** Here you can have the builder or architect give you the component
breakdown on the attached form, *Schedule of Building Structural Components*. In this case consider doing this, even for properties under $500,000 and without a cost segregation consultant and of course using the form of this chapter.

3. For each real property component, use the same recovery period of 27-1/2 years for residential rental property, or 39 years for non-residential real property. This is required under Regulation 1.168-2(e).

4. Use separate depreciation schedules for each real property component. With today’s technology this should not be difficult.

5. Do the proper IRS reporting deducting the remaining balance of the retired real property component as an ordinary loss on form 4797, Part II as previously illustrated in this chapter.

**Goldmine Form To Use:** *FORM 6* in Forms Appendix in the SAP’s - *Schedule of Building Structural Components*. Also see below.

---

**Schedule of Building Structural Components**

*(Blank format for internal use only)*

Investor name: __________________________________________________________

Date purchased: _____/_____/______ Date placed in service: _____/_____/______

Property type: __________________________________________________________

Property address: ________________________________________________________

<table>
<thead>
<tr>
<th>Description of Building Structural Components</th>
<th>Age</th>
<th>Condition <em>(G, F, P)</em></th>
<th>Cost**</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Attic finish..........................................................</td>
<td></td>
<td></td>
<td>+$</td>
</tr>
</tbody>
</table>
2. Bathroom fixtures, permanent (no. of bathrooms__)......... +
3. Balconies................................................................. +
4. Ceilings, permanent (no. of rooms in property__).......... +
5. Doors, exterior (no.__)............................................. +
6. Doors, interior (no.__)............................................. +
7. Electrical system.................................................... +
8. Fire escape.................................................................. +
9. Fire protection system (building)................................. +
10. Fire place.................................................................... +
11. Foundation............................................................. +
12. Floor structure....................................................... +
13. Floor cover, permanent............................................. +
14. Garage (see part II for breakdown).............................. +
15. Heating\AC system, duct work and grilles ................. +
16. Lighting, permanent................................................ +
17. Plumbing system.................................................... +
18. Porches...................................................................... +
19. Roof.......................................................................... +
20. Roof dormers.......................................................... +
21. Stairways, exterior.................................................... +
22. Stairways, interior.................................................... +
23. Stairway entrance..................................................... +
24. Walls, exterior.......................................................... +
25. Walls, interior, permanent weight bearing (no.____)..... +
26. Windows (no.____).................................................... +
27. Other......................................................................... +

TOTAL .............................................................................. = $

*G - good;  F - fair;  P - poor); **Determine the cost of the components from professional appraisal books, such as Marshall & Swift’s or contact an appraiser or other valuation expert.

Reference Source (return tab): SAP 6, Part C

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred,
reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Section 179 First-Year Expensing of Certain Personal Property Associated With Real Estate

Reference Source (return tab): SAP 6, Part D

Instead of depreciating business personal property over 5 (or 7) years, with Section 179 first-year expensing, you can fully deduct all in one year the cost of qualifying personal property up to certain dollar limits (in part C of this chapter). This means even faster tax dollars in your pocket!

In this chapter, related to componentizing, we will cover...

A. QUALIFYING SECTION 179 PERSONAL PROPERTY - BUSINESS-USE REQUIREMENT – NEW OR USED

B. NOT ALL PERSONAL PROPERTY WITH REAL ESTATE QUALIFIES

B-1. EXAMPLES OF FIRST-YEAR EXPENSING AS IT PERTAINS TO PERSONAL PROPERTY IN REAL ESTATE

C. DOLLAR LIMITS ON THE 179 DEDUCTION

D. TAX PLANNING STRATEGIES TO INCREASE THE NET INCOME LIMIT

E. PROPERLY & TIMELY ELECTING AND REPORTING THE SECTION 179 DEDUCTION

F. AUDIT-PROOFING FOR THE 179 DEDUCTION

G. POSSIBLE 15% REQUIREMENT

A. QUALIFYING SECTION 179 PERSONAL PROPERTY - BUSINESS-USE REQUIREMENT – NEW OR USED
1. Qualifying property. To qualify for 179, the depreciable personal property must be for use in an active business, as opposed to an investment, held just for the production of income, IRC 179(d)(1). This is generally not a problem because rental real estate is generally considered to be an active business. (With Goldmine planning it will be. For a further discussion, see Chapter 3).

2. New or Used Purchased From Unrelated Party: It can be new or used personal property but must be purchased from an unrelated party as per IRC 267(b) and IRC 179(d).

B. NOT ALL PERSONAL PROPERTY WITH REAL ESTATE QUALIFIES

1. 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 entitled to the 5 year write-off.

2. 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. Apparently, it can also be used for personal property in vacation rentals where the average tenant use is 30 days or less and significant personal services, such as maid services, are provided (similar to hotels).

3. First-year expensing can be used for personal property associated or ancillary to any type of investment 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, laundry equipment, storage units, shelving, movable sheds and movable garages. These would also qualify for the full Section 179 deduction as ancillary items for both residential rental or for commercial property.

B-1. EXAMPLES OF FIRST-YEAR EXPENSING AS IT PERTAINS TO PERSONAL PROPERTY IN REAL ESTATE

Example 1 - Non-qualifying residential rental personal property: You purchase a small apartment building, which includes $15,000 of appliances, carpets, kitchen cabinets and other personal property. While you can depreciate the property over 5 years, you can not fully expense the personal property under Section 179. **Reason:** The property is depreciable personal property in residential rental property as described in Section 50(b), as per number 1 above.

Example 2 - Qualifying commercial personal property: Same facts as 1 above, except the above property is an office building. You can fully expense the personal property under Section 179. **Reason:** The property is depreciable personal property in commercial property as per number 2 above.

Example 3 – Mixed-use commercial personal property (qualifying) and residential rental personal property (not qualifying): You purchase a property that has commercial units on the first floor and apartments on the second floor. For the personal property pertaining to the commercial units, you can fully expense the personal property under Section 179. **Reason:** The property is depreciable personal property in commercial property as per number 2 above. For the personal property pertaining to the residential units, you cannot fully expense it under 179. **Reason:** The property is depreciable personal property in residential rental property as described in Section 50(b), as per number 1 above.

Example 4 – Qualifying personal property associated or ancillary to any type of investment real estate, residential or commercial: You buy office
equipment (computer, printer, fax, etc.) for your home-office which you use to manage all of your properties (residential and commercial). You also buy maintenance equipment for the properties, such as lawn mowers, snowmobiles, tools, etc. You can fully expense all of this personal property under Section 179. **Reason:** The property is depreciable personal property in the *business* of managing and maintaining your properties as per number 3 above.

**C. DOLLAR LIMITS ON THE 179 DEDUCTION**

1. **Overall dollar limits.** Presently the amount of qualifying depreciable personal property that can be fully deducted in one year via Section 179 first year expensing is $250,000. In addition, the full $250,000 expensing can be claimed until $800,000 of assets is placed in service in up from $510,000.

1A. **Updates\more info.** However the above could be subject to change or expiration. For any changes, email us with your *Renaissance* VIP code.

2. **Net income limits.** Section 179 first year expensing is limited to the net income of your business. But **179 can take your business income down to zero!** Plus, you can carryover the unused balance. IRC 179(b).

2A. **Example.** Your 179 deduction is $10,000. Your rental property schedule shows net income of $5,000. You deduct $5,000, get your net income down to zero and you carryforward the remaining $5,000 in the following year and thereafter until used up.

**D. TAX PLANNING STRATEGIES TO INCREASE THE NET INCOME LIMIT**

1. **Include other business income** - If your properties’ tax reporting is on Schedule E, you can increase this deduction limit by including salaries and other net business income. On a joint return, you can also include your spouse’s taxable income. This is so even if the income (including salaries) has nothing to do with real estate.
1A. Example. Your 179 deduction is $10,000. Your Schedule E shows net income of $5,000, plus $5,000 in salaries. Now you deduct the entire $10,000 and your Schedule E now has a $5,000 deductible loss against your other income.

1B. But not with entities. This strategy will not work with entities such as limited liability companies (LLC’s), partnerships and corporations, even if they are pass-thru entities such as LLC’s, partnerships or S-corps. Reason: For these entities, the net taxable income applies to the LLC, partnership or S-corporation itself, as well as the partners or shareholders as individual taxpayers. The partnership, LLC or S-corp determines its first year expensing deduction subject to these limits and then allocates the deduction, if any, among the partners, members or shareholders.

The allocated deduction cannot exceed the net taxable income of the partnership, LLC or S-corporation. An individual partner, member or shareholder’s expensing deduction may not exceed the annual limit regardless of how many partnerships, LLC’s or corporations they have ownership in. But see next strategy below.

2. Accelerate next year’s business income – Here you accelerate next year’s business income into the current year to take full advantage of the entire 179 deduction.

2A. Example. Your 179 deduction is $10,000. Your rental property schedule shows net income of $5,000, but no other business income. You could deduct $5,000, get your net income down to zero and then carryforward the remaining $5,000 in the following year. However, suppose next year you are due additional income (rents, fees, bonuses, etc.) of $5,000. If you receive the $5,000 additional income this year, you can use the remaining $5,000 Section 179 deduction to fully offset the bonus and pay NO income taxes on this income.

2B. Both for Schedule E or entities. This strategy could work for Schedule E or entities such as an LLC.
3. Other limits. With 179, certain other limits apply if annual purchases exceed a present amount of $800,000. Check instructions to a current IRS form 4562.

E. PROPERLY & TIMELY ELECTING AND REPORTING THE SECTION 179 DEDUCTION

1. Form 4562, Part 1. To deduct first-year expensing it must be elected for the year of purchase by completing IRS Form 4562 (depreciation schedule), Part I. IRC 179(c)(1) states that the election must specify the items and costs of personal property being deducted under Section 179. Insert this on Part I, of Form 4562, “Section 1245 business assets, as per my backup detail”. See below.

Election To Expense Certain Property Under Section 179

<p>| | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1.</td>
<td>Maximum amount. See the instructions for a higher limit for certain businesses</td>
<td>$250,000</td>
</tr>
<tr>
<td>2.</td>
<td>Total cost of section 179 property placed in service (see instructions)</td>
<td>$2,125</td>
</tr>
<tr>
<td>3.</td>
<td>Threshold cost of section 179 property before reduction in limitation</td>
<td>$800,000</td>
</tr>
<tr>
<td>4.</td>
<td>Reduction in limitation. Subtract line 3 from line 2, If zero or less, enter 0</td>
<td>0</td>
</tr>
<tr>
<td>5.</td>
<td>Dollar limitation for tax year. Subtract line 4 from line 1. If zero or less, enter 0. If married filing separately, see instructions.</td>
<td>$250,000</td>
</tr>
</tbody>
</table>

Keep the detailed list of the assets in your own files. You must elect Section 179 by the following April 15th, plus proper extensions to file. See next.

2. Amended returns for missed 179 elections. Generally past April 15th, plus proper extensions to file, you cannot make the election even with an amended return. However at the present time the Section 179 election can be made (or revoked) on amended returns without IRS consent. Reg. 1.179-5T. For updates and changes, check with us with your VIP code.

F. AUDIT-PROOFING FOR THE 179 DEDUCTION

1. Audit risk. Generally speaking, the 179 deduction should not be considered aggressive or a red flag. Provided you adhere to its requirements, it’s a clear-cut deduction as permitted by the Internal Revenue Code (179), which is law. But, when taken for qualifying personal property associated with real estate, it may be a red flag, especially on Form 1040-Schedule E. Reason: IRS agents are used to
seeing the deduction go from Form 4562 to Schedule C - "Profit or Loss From Business" - as opposed to Schedule E - "Supplemental Income and Loss". In fact, I was told that at least one 1040 software tax preparation program automatically rejected the 179 deduction for qualifying personal property associated with real estate. (This is why computer programs have “overrides”).

2. Audit proofing techniques:

(1) Avoid Schedule 1040-E altogether and file a partnership return (Form 1065). This alone can do it, because Form 1065 is more of a generic schedule used for both rental properties and regular active businesses. If you do this, you should still adhere to the next planning recommendation.

(2) Behind Form 4562 (depreciation schedule), attach the following statement below.

**Statement of Eligibility To Elect 179 First Year Expensing**

Tax year: ________. Taxpayer name: 

__________________________________________

Taxpayer identification number: 

_____________________________________________

The deductibility of the Section 1245 property listed in Part I of form 4562 is permitted under Section 179 because it is qualifying depreciable personal property that is acquired by purchase from an unrelated party per IRC 267(B) for use in an active business, IRC 179(d)(1); IRC 707(b). The property is not personal property in a residential rental property as described in Section 50(b) which includes “Property used for lodging” (residential rental properties).

G. POSSIBLE 15% REQUIREMENT

I think this requirement does not pertain to personal property associated with real estate. But read on.
1. **15% requirement (maybe):** Another requirement for first year expensing is that the property’s Section 162 business expenses must exceed 15% of the property’s gross income, IRC 179(5)(b). IRC 162 expenses are all property expenses except the following: Taxes (IRC 164), interest (IRC 163) and depreciation (IRC 167, 168). Examples of IRC 162 expenses are advertising, auto, travel, cleaning, maintenance, supplies, repairs, insurance, legal fees, other professional fees, management fees, utilities, entertainment, telephone, office supplies, postage, salaries, publications on real estate, equipment rental, eviction costs, dues for investor associations, tuition for RE seminars.

1A. **Example:** Sam purchases equipment which he then leases out to others for $5,000 a year. Sam’s IRC 162 expenses related to this equipment are $800, which is 16% of the $5,000 rental. Accordingly, Sam can elect first-year expensing on the equipment.

If his expenses were $750 or less, first-year expensing would not be permitted, because he would have flunked the 15% test. (Sam could then depreciate the equipment over 5 years.) The obvious planning strategy is to incur at least 15.1% of IRC 162 expenses.

2. **How does the 15% requirement relate to personal property with real estate?** How would this 15% test pertain to personal property associated with real estate where the tenant is paying one rental for the entire property (real & personal)? From a practical viewpoint it would be difficult because so much of the total rent and IRC 162 expenses would have to be allocated to the personal property to see if the test is met. Even if some allocation is made, many rental properties could qualify as there are a large number of IRC 162 expenses as listed above.

The creative strategies of this publication, such as maximizing repair & maintenance deductions (Ch. 18), would help this situation even more so. (Also, Ch. 23 for other deductions) On the other hand, “net lease” properties (where tenants pay most of the expenses) probably would not meet the 15% test.
There is another aspect to this issue. In the first place, is this 15% requirement intended to apply to personal property associated with real estate?

Or, is it just intended to apply to those lessors in the business of just leasing personal property, such as equipment? As IRC 179(5)(b) uses the words “lessors”, I think - it does not pertain to personal property associated with real estate. But that’s my viewpoint. Others may differ.

Reference Source (return tab): **SAP 6, Part D**
More Depreciation Alerts And Strategies for Building Depreciation

Reference Source (return tab): SAP 6, Part E

In this chapter, related to depreciation, we will cover...

A. ALERT FOR RESIDENTIAL REAL ESTATE VS. NON-RESIDENTIAL REAL ESTATE – 27-1/2 YRS. V. 39 YRS

B. ALERT ON DEMOLITION OF THE ENTIRE BUILDING STRUCTURE = LOSS OF DEPRECIATION DEDUCTIONS

C. SOME BUILDING STRUCTURES ARE DEPRECIATED OVER LESS THAN 27-1/2 YEARS = HIGHER DEDUCTIONS

D. HISTORY OF DEPRECIATION METHODS FOR THE BUILDING

A. ALERT FOR RESIDENTIAL REAL ESTATE VS. NON-RESIDENTIAL REAL ESTATE – 27-1/2 YRS. V. 39 YRS

1. With the building 27-12 years is still better than 39 years. There could be a fairly significant difference in tax savings periods for residential rental property at 27-1/2 years versus non-residential realty at 39 years.

2. Residential real estate vs. non-residential real estate. It has nothing to do with local zoning, or the size of the property. It is determined by a technical tax law definition: A residential rental property is a building in which 80% or more of the gross rents are from dwelling units [IRC 167(j)(2)(B)]. (A dwelling unit is a house or apartment used to provide living accommodations.) In other words, if
21% or more of the gross rents are from commercial units, then the property is considered non-residential real estate and you must use 39 years on the entire building even the residential rental portion. If any part of the building is occupied by the taxpayer, the gross rental value will include the rental value of the occupied portion, IRC 167(j)(2)(B).

3. **Also hotels or motels are non-residential.** Residential realty does not include units in a hotel, motel or other such properties in which more than one-half of the units are used in a transient basis, IRC 167(j)(3)(C). Thus, hotels, motels and the like are also considered non-residential real estate and must use 39 years, IRC 168 (b)(3)(C). On the other hand, you can use 27-1/2 years on a large 1000 unit apartment building.

4. **No prorating.** You do not pro-rate the one property into a dual property (on the same deed), one, residential; the other, non-residential. It’s an all or nothing test.

5. **Mixed-used property is the issue.** The problem comes with mixed-use residential and non-residential property, such as retail units with apartments all on one deed.

5A. **Example—Mixed use property:** Ivan Investor buys a 4-unit-property. The first floor is a store and the remaining three units are apartments. Each unit rents for $400 a month or total of $1,600. The three apartments at $400 each total $1,200, divided by $1,600 = 75%, which is less than 80%. Thus, the entire property is non-residential and must use 39 years, not 27-1/2.

6. **Three planning strategies to get 27-1/2 years, not 39 years:**

(1) **Convert the commercial unit to an apartment.** The entire property would then be all residential. [Note: This also may advantageous from a financial viewpoint as apartments are generally much easier to rent than retail units. Also, a 100% residential rental property is easier to finance and sell than a mixed-use, commercial/residential property].
(2) Separate the units into condos. Now you have separate properties with their own separate definitions of residential and non-residential. [Note: This too may be advantageous from a financial viewpoint as you can sell (or exchange) off the separate condos for a profit. Of course you have to check the financial and legal feasibility of doing so, as well as current market conditions].

(3) Attain the required percentage of 80% (or greater) by converting the non-residential unit (the store) from a gross lease to a “net lease” where the tenant pays you a lower rent, but also pays for more of the expenses. See example below

6A. Example 1 – Lower rent with net lease: Assume the same facts as Example 1, except that for the store you do a net lease of $300 a month. The total rents would now be $1,500. The three apartments at $400 each total $1,200, divided by $1,500 = 80%, Bingo! You got your 80%!! Accordingly, the entire property is a now residential and uses 27-1/2 years, not 39. [This too may be advantageous because net leases are usually less management headaches.]

6B. Year by year for 80% test. The above can be feasible planning ideas as this rule is a year-by-year test. Thus, in any year the 80% test is met, the taxpayer can start to use the faster 27-1/2 years. Presumably, the 27-1/2 years would begin in the month of the year of the change to 80%.

B. ALERT ON DEMOLITION OF THE ENTIRE BUILDING STRUCTURE = LOSS OF DEPRECIATION DEDUCTIONS

1. Total demolition building basis becomes land basis = no depreciation deductions for building. If a building structure is totally demolished, the remaining basis of the building and the costs of demolition must be added to the basis of the non-depreciable land on which the building is situated, IRC 280B. (Emphasis added). This means no more building depreciation deductions. [Note:
Prior to January 1, 1984, there was much more favorable treatment in that a full loss deduction was allowed for the remaining basis of the building, plus demolition costs.]

2. Planning strategies for demolition:

(1) **Write off the remaining basis of “personal” property items, if you do totally demolish the building.** For the purposes of the above limited tax treatment, the building “structure” includes structural components such as walls, floors, ceilings and other permanent coverings such as paneling, tiling, windows and doors. Also included are central air & heating systems, plumbing, plumbing fixtures, electrical wiring, light fixtures, chimneys, stairs, escalators, elevators, building sprinkler systems and fire escapes, Proposed Reg. 1.280B-1. It appears that most 5-year personal property items do not come under this limitation. Thus, you should be able to fully deduct the remaining basis of personal property items as per Chapter 12.

(2) **Renovate the building instead of demolishing it.** This way you have a five-fold benefit:

(a) You may be able to write off the remaining basis of any building components that have been replaced. See Chapter 12-D for a further discussion.

(b) For any building components not replaced, you can continue to take depreciation deductions.

(c) Any incidental demolition costs (such as for partial demolition) can be capitalized as part of the building and then written off via depreciation deductions, or fully written off as repairs as per Chapter 18.

(d) The costs of renovation to an existing building may be eligible for rehabilitation tax credits as per Chapter 20.
(e) Certain renovations for the handicapped also receive preferential tax treatment under IRC 190 or IRC 44 as per Chapter 18-A, part A.

C. SOME BUILDING STRUCTURES ARE DEPRECIATED OVER LESS THAN 27-1/2 YEARS = HIGHER DEDUCTIONS

1. Ten years - Single purpose agricultural or horticultural structures are depreciated over 10 years.

2. 20 years - Other farm buildings are depreciated over 20 years.

3. 20 years - Municipal sewers are 20 years.

4. 15 years - Non-municipal sewers are 15-year land improvements as per Chapter 12-B.

5. More info for above. IRS Publication 946.

D. HISTORY OF DEPRECIATION METHODS FOR THE BUILDING

Depreciation is also referred to as "Cost Recovery", "ACRS" or presently, "MACRS" (Modified Cost Recovery System).

<table>
<thead>
<tr>
<th>Date Building Placed In Service</th>
<th>Depreciation Life or Recovery Period</th>
</tr>
</thead>
<tbody>
<tr>
<td>February 12, 1913 to December 31, 1980</td>
<td>Estimated useful life</td>
</tr>
<tr>
<td>January 1, 1981 to March 14, 1981</td>
<td>15 years - ACRS</td>
</tr>
<tr>
<td>Date Range</td>
<td>Method</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-----------------</td>
</tr>
<tr>
<td>March 15, 1985 to May 8, 1985</td>
<td>18 years - ACRS</td>
</tr>
<tr>
<td>May 9, 1985 to December 31, 1986</td>
<td>19 years - ACRS</td>
</tr>
<tr>
<td>January 1, 1987 to May 12, 1993</td>
<td>27-1/2 yrs. res. 31-1/2 yrs/ nonres. - MACRS</td>
</tr>
<tr>
<td>May 13, 1993 to present</td>
<td>27-1/2 yrs. res. 39 yrs. nonres. - MACRS</td>
</tr>
<tr>
<td>1973 to present</td>
<td>Componentizing permitted</td>
</tr>
</tbody>
</table>

Reference Source (return tab): **SAP 6, Part E**

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the intermit) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
RS agents will frequently try to disallow depreciation (and other) deductions during a period that a property is vacant. Our discussion is broken down into three main categories:

| A. PROPERTY THAT IS VACANT, BUT IS READY TO RENT – PLANNING STRATEGIES |
| B. PROPERTY THAT IS VACANT, BUT IS NOT READY TO RENT – PLANNING STRATEGIES |
| C. AUDIT PROOFING STATEMENT FOR A RENTAL PROPERTY THAT IS NOT ACTUALLY RENTED |

**A. PROPERTY THAT IS VACANT, BUT IS READY TO RENT**

1. **Rentable with profit intent = depreciation deductions.** In plain language, this means that if a property is rentable or usable, then it is entitled to depreciation (and other) deductions, even if the property is vacant, provided there is a genuine *intent for profit* and the taxpayer has proof of this intent.

2. **Tax law support.** If the property is considered to be placed in service, then depreciation (and other) deductions should be permitted, Regulation 1.167(a)-10(b). A property is considered to be placed in service when it is in a condition or state of readiness and availability for a specifically assigned function whether in a trade or business, or for the production of income,
Revenue Rulings 76-238 and 84-23; Revenue Procedure 87-57 and IRS Publication 534.

3. **Burden of proof on the investor.** It must be proven by the taxpayer that the property is ready, available and capable to perform its intended function, *Julian Von Kalinowski*, 65 TCM 1788, TC Memo 1993-26.

4. **Strategies to demonstrate intent for profit.** Do this by:

   (1) Attempting to actively rent the property by way of newspaper ads, “for rent” signs, the internet, listing contracts, flyers, etc. Keep copies of these supporting documents.

   (2) Take pictures of the outside and inside of the property, indicating its readiness. Also take pictures of the “For Rent” sign. Date the pictures.

   (3) Besides for rent, having the property up for sale also helps to demonstrate intent for profit. For a further discussion of documenting intent for profit, see Chapter 27.

B. **PROPERTY THAT IS VACANT, BUT IS NOT READY TO RENT**

1. **Know the tax law and plan in advance.** If you know the tax law and plan in advance, you still may be able to claim depreciation (and other) deductions even when a property is vacant and not ready to rent.

2. **Tax law support.** This is supported by Regulation 1.212-1(2)(b) which states, “The term ‘income’ for the purposes of Section 212 includes not merely income of the taxable year, but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years;
and is not confined to recurring income but applies as well to gains from the disposition of property.

(a) **Section 212** - Ordinary and necessary expenses paid in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income there from in the taxable year. Expenses paid in managing, conserving, or maintaining property held for investment may be deductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto” (Underline emphasis added.)

(b) **Sections 162, 167, 212** – Internal Revenue Code Section 167 (a) states that depreciation is allowed with respect to property used in a trade or business (IRC 162), or held for the production of income (IRC 212). Thus, there is a definite inter-relationship between real estate, depreciation and ordinary & necessary expenses under IRC 212. Both IRC 212 and IRC 162 apply to rental real estate. See IRC 162.

(c) **Case law supporting Section 212** - Regulation 1.212-1(2)(b) is also supported by case law. This court permitted depreciation deductions with respect to property not currently producing income but held for sale at a profit and actually sold at a profit. The court held that property is “income-producing”, for purposes of the depreciation deductions where it produces recurring income such as rent, but also includes income in the form of the expectation of gain from the disposition of the property, *Mitchell* (1966), 47 TC 120.
(d) **Tax Court case where property was offered for lease or sale** - In *Riss* (23 TCM 1113, 1964), the taxpayer was entitled to depreciation from the date the property was first offered for sale or lease and not from the date when the property was put into productive use. The tax court held that the property was held for the production of income although it actually produced no income until it was actually rented.

(e) **Taxpayer victory, but don’t do it this way** - In another case, the taxpayers did not advertise a vacant apartment and waited until immediately before the new tenants moved in to install new fixtures and repaint the walls. Despite this, the property was held for the production of income. It was considered sound business practice to do so, *Moyland*, TC Memo 1968-15.

**TIP**: Good back-up support but don’t do it this way!

(f) **Another taxpayer victory, but again don’t do it this way** - Depreciation was allowed on resort property acquired for business use even though it produced little revenue and was used rent-free part of the time by religious organizations which the taxpayer hoped to interest in purchasing the property, *Lorraine Corp.*., TC Memo 1958-141.

(g) **Taxpayer victory and defeat, do not abandoned the property** - The tax court permitted rental deductions for an apartment that was vacant for 10 years because the property was in a run-down area. But when the taxpayer gave up trying to locate a tenant and boarded up the building, the IRS and Tax Court held that the property was abandoned for rental and deductions were disallowed [*Gertrude Gorod*, 81632 P-H Memo (1981), permitted deductions; and 85023 P-H Memo TC, 787 F2d 578 (CA2, 1986), disallowing deductions].
**TIP:** The taxpayer may be able to claim an abandonment loss; see ch. 45.

(h) **A good IRS ruling** - In one of their own letter rulings (7931008), IRS permitted a partnership to deduct operating expenses on an office building during an 8 month period in which tenants were vacated and the building renovated before old and new tenants moved in.

3. **Strategies for taking depreciation deductions on vacant property not ready to rent:**

(1) **Market the property for rent.** Ads, flyers, the internet, list with a Realtor, place a rent sign on the property and take a picture of the sign.

(2) **Market the property for sale.** Ads, flyers, the internet, list with a Realtor (MLS), place a sales sign on property, take a picture of the sign.

**Note:** This strategy is consistent with previously cited Regulation 1.212-1 (2)(b) which states that income is not just recurring income (rents), but that which “may realize in subsequent taxable years and apply as well to gains from the disposition of property” (sales).

(3) **Numbers 1 and 2 should be both done simultaneously.** That is attempt to **both rent and sell** the property at the same time. Doing this will be in accordance with Reg. 1.212-1 (2)(b).

**Note:** The above two simultaneous strategies are consistent with *Jephson* (1938) 37 BTA 1117. Here, the taxpayer was ruled to be engaged in a trade or business, because when they purchased the rental property they listed it for rent with a broker and showed it to prospective tenants. Even though they failed to rent it, they still were considered to be in a business entitled to claim deductions.
(4) If practical, have prospective tenants complete rental applications and accept rental deposits. This is not only good tax planning, but also sound property management. (Accepting rental deposits should be done in accordance with state landlord-tenant laws).

(5) Do not occupy the property for personal use. In one case the taxpayer was not allowed to deduct depreciation during the period that they occupied it as a temporary summer residence, Ford, Jr., (1957) 29 TC 499. IRC 280A.

(6) **Document the above planning strategies** by keeping copies of newspaper ads, pictures of rent and sales signs, copies of rental applications, listing agreements, canceled checks, emails and any other documentation, indicating intent for profit. When it comes to IRS audits, the single most important factor is the proper recordkeeping & documentation. “An ounce of recordkeeping is worth a pound of argument”.

---

**C. AUDIT-PROOFING STATEMENT FOR A RENTAL PROPERTY THAT IS NOT ACTUALLY RENTED**

1. Use the following audit-proofing statement and insert it behind the IRS rental property form (Schedule E or the highly preferred partnership 1065).
FOR A RENTAL PROPERTY THAT IS NOT YET ACTUALLY RENTED and/or HIGH EXPENSES IN RELATION TO RENTAL INCOME

Insert this audit reduction statement behind the IRS rental property form:

All of my deductions are legitimate and I have recordkeeping proof. I am an active real estate investor, who actively manages the property with the primary intent for profit as per Internal Revenue Code Section 183. If a property is not rented at any given time, documented and vigorous attempts are made to quickly rent the property in the way of newspaper ads, “for rent” sign, the internet, listing with a real estate agent or management company, flyers, etc. Also, separate business records are kept. During any vacant period the property is not at all used personally by an owner or a related party as per Internal Revenue Code Sections 280A and 267(b).

NOTE TO USER: You can also include reasons why the property is not rented or for high expenses in relation to rental income such as: The rental market in this area has been slow, non-paying tenant, unqualified tenants, poor real estate market, illness, family problems, etc.

TIP: Sign and have the above statement notarized for more credibility.

Reference Source (return tab): SAP 6, Part F

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Getting Back Missed Depreciation Deductions
Not Wasting Depreciation Deductions

A. FILING FOR PRIOR MISSED DEPRECIATION DEDUCTIONS
B. DO NOT WASTE DEPRECIATION DEDUCTIONS; SAVE FOR A LATER YEAR WHEN YOU WILL NEED THEM
C. ALTERNATIVE DEPRECIATION SYSTEM (ADS)

A. FILING FOR PRIOR MISSED DEPRECIATION DEDUCTIONS

1. Three years or less – amended returns. If you missed any depreciation and have owned the property for three years or less, then get it back by filing a separate amended return for each year you are amending as follows:

(1) Individuals - File IRS Form 1040X to the IRS service center where you live now (not the address on the original return if this were different.) It often takes 2 to 3 months to process the 1040X.

(2) State Returns - If your state or local returns are affected, file an amended return with them.

(3) Corporations - C-Corporations file form 1120X. For S-corporations, file an amended 1120S and follow the instructions for form 1120S. An amended K-1 schedule (form 1120S) must also be filed with the amended 1120S and given to the shareholders.
(4) **Partnerships/LLC’s** - For partnerships/LLC’s, file an amended 1065 and check box 5 on form 1065. An amended K-1 schedule (form 1065) must also be filed with the amended 1065 and given to the partners.

**2. Before three years (closed years) – IRS Form 3115.** If you missed any depreciation, and have owned the property for more than three years, then get it back all in one year without having to file amended returns.

(1) **Cumulative catch-up depreciation** - Instead you can do “catch-up” depreciation and claim the understated deductions (including closed tax years) as a current year deduction. It is called a “Section 481(a) adjustment”.

(2) **You take the entire catch-up depreciation deduction all in the year of change.** Any such catch-up depreciation reduces the basis of the property and would therefore increase any gain on the disposition of the property. It would anyway because you still have to reduce the basis of the property by the accumulated depreciation, which in effect, is adding back to gain depreciation allowed or *allowable*. Moreover, don’t forget the tax savings from the catch-up deduction and that a 1031 exchange can defer all of the taxes on your gain!

(3) **Form to file\tax law cites** - Do this by filing for automatic IRS consent via IRS Form 3115 - *Application for Change in Accounting Method*. Revenue Procedures: 2008-52; 2002-19; 2002-9; 97-37; 96-31.

(4) **How to file\tax law cites** - Form 3115 can be filed by at any time during the year, not just during the first 180 days [Reg. 1.446-1T(e)(3)(i)(B); Rev. Proc, 97-37]. Not all of the lines of the form have to be filled in. At the top of form 3115, insert “Automatic Method Change under Revenue Procedures 2008-52, 96-31 and 97-37”. Also see Revenue Procedure 99-49. For directions refer to Section 5 of Rev. Proc. 96-31 which can be obtained from your tax advisor or the Freedom of Information Reading Room at IRS Headquarters, Box 795, Ben Franklin Station, Washington, DC 20044; or call, (202) 512-1716 (“fax watch”); (202) 512-1800, (202) 622-1658 or 1-888-293-6498. Alternatively you can have a competent specialist complete the form for you. Contact us for a referral.
(5) **Where to file** - See the form’s instructions where to mail. Send certified. Also, attach a copy of the completed 3115 to your own tax return where you are claiming the catch-up depreciation.

(6) **Do the election before you sell the property** -- This option only pertains to property held by the taxpayer at the time of the change. If the taxpayer sells or disposes of the property and no 3115 election has been made by December 31, the catch-up depreciation is not available*. But you have to still add back to gain all depreciation allowed or *allowable, which includes any missed depreciation. (*In this case you can do an amended return (1040X) to recoup missed depreciation for the past three years only.)

3. **Amended return versus 3115.** Some may take the position that even for three years or less, file form 3115. But in this scenario of three years or less, many tax experts prefer the amended returns of number 1 above.

**B. DO NOT WASTE DEPRECIATION DEDUCTIONS; SAVE FOR A LATER YEAR WHEN YOU WILL NEED THEM**

1. **Depreciation is mandatory.** You must take it. IRC 167(a); IRC 167(c)(1); IRC 168(a). If you do not you still have to reduce the property’s basis by what should have been the allowable depreciation when you sell or dispose the property, IRC 167(e)(3). Reducing the basis by the allowable depreciation is in effect adding it to the gain, again whether or not you took the depreciation. Many investors erroneously do not take the depreciation because they do not need the deduction and then get an unpleasant surprise when they sell the property with the added phantom depreciation, increasing their gain. But there is a solution, see next.

2. **The solution - with catch-up depreciation you can hold-off taking depreciation deductions in years you are in a low tax bracket.** When you are later in a high tax bracket year and need the deduction, then you
can claim the catch-up depreciation deduction, via Form 3115 (not an amended return).

2A. Example: Irma Investor buys a rental property. For the first three years she is in a low bracket and does not need the depreciation deductions so she forgoes claiming any depreciation deductions for the first three years. Assume that her depreciation deductions allowable for each year are $5,000 or $15,000 for three years. In year four Irma is in a high income bracket and needs deductions. Using Form 3115, in the fourth year Irma can claim the catch-up accumulated depreciation deduction of $15,000, plus the $5,000 depreciation deduction for year four, or a total of $20,000. Irma astutely employs superior tax reduction strategies by taking the deductions when she needs them the most.

3. The larger the property the better. This tax-deduction strategy will be even more effective for larger commercial properties,

C. ALTERNATIVE DEPRECIATION SYSTEM (ADS)
ADS is an optional depreciation method where you can elect a straight-line (SL) method with substantially longer recovery periods. The ADS system should be used in two situations

**1. This one is optional.** You are in a low tax bracket and therefore do not need additional tax deductions and any more deductions would be wasted as they would not create or add to a net operating loss (NOL), as discussed in Chapter 28. So here you would elect ADS straight-line depreciation. Also, see in this chapter, part B on using Form 3115 for not wasting depreciation deductions.

**2. This one is mandatory.** You must ADS for purposes of computing alternative minimum tax (AMT), discussed in Appendix F (PAPPF). For more about ADS (Alternative Depreciation System), see IRS Publication 946.

Reference Source (return tab): SAP 6, Part G

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright  All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
16-A

IRS Audit Proofing Strategies
For Componentizing

Reference Source (return tab): SAP 6, Part H

In this chapter we will cover...

A. TAX-SAVING (BUT CORRECT) COMPONENT ALLOCATIONS WILL NOT INCREASE CHANCES OF AN IRS AUDIT

B. AUDIT-PROOFING TECHNIQUES

A. TAX-SAVING (BUT CORRECT) COMPONENT ALLOCATIONS WILL NOT INCREASE CHANCES OF AN IRS AUDIT

1. Reported on form 4562. This is because when you file your tax return, the depreciable components are reported on IRS Form 4562 (Depreciation). The first year you own the property this schedule will ask for the total amounts of what they call “5-year property” (personal property), “15-year property” (land improvements), “Residential rental property” (building), and “Nonresidential real property” (building). Just fill in the totals (not detail) of the depreciable components. See next.

2. Do not have to give detail or land value. Form 4562 only asks for the total of these components. It does not ask for detail. And the big plus it does not ask for the allocated land value. The IRS has no idea of any low land value. They will not even know what you paid for the property.

3. Computer technology for depreciation computations. Tax preparation software (such as TurboTax or TaxCut) greatly simply depreciation
computations. However, you still should use my special forms (in the previous depreciation chapters and the forms disk) of the *Multi-Component/Land-Residual Method TM*.

**B. AUDIT-PROOFING TECHNIQUES**

Despite the above and just to be certain, here are some audit-proofing tips:

(1) **Detail is your own back-up file** - You should only keep the detail of your depreciation breakdowns and allocations in your own back-up file, using the Goldmine forms. Do *not* file these forms with your return. You do not have to! (unless I tell you otherwise).

(2) **Even less detail in later years** - In subsequent years, you do not have to show anything about these original allocated components, except for the one total amount of depreciation deductions, which is all on one line on form 4562. Any new additions must be shown, but only in a total category as per the above.

(3) **File form 1065** - Avoid the more audited Schedule 1040-E altogether and file a partnership return (Form 1065), preferably an LLC-partnership. See Chapter 5 for a further discussion of partnerships and LLC’s.

Reference Source (return tab): **SAP 6, Part H**

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY
Unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Repair Deductions Versus Capital Improvements – An Introduction

In this chapter we will cover...

A. THREE POWERFUL TAX-SAVING ADVANTAGES OF REPAIR DEDUCTIONS

B. GENERAL GUIDELINES – REPAIRS VS. IMPROVEMENTS

C. THERE ARE TAX-REDUCTION STRATEGIES TO CONVERT CAPITAL IMPROVEMENTS INTO FULLY DEDUCTIBLE REPAIRS

A. THREE POWERFUL TAX-SAVING ADVANTAGES OF REPAIR DEDUCTIONS

1. IMMEDIATE TAX SAVINGS. Repairs are fully deductible against all types of income including ordinary income, including your spouse’s income on a joint return. On the other hand, a “capital improvement” is not fully deductible all in one year but must be depreciated over a recovery period of 27-1/2 years for residential real property and even longer at 39 years for non-residential real property. Personal property is depreciable over 5 or 7 years.

EXAMPLE: The owner of a rental property is in the 31% tax bracket and pays $10,000 as a repair. Consequently, the owner gets an immediate deduction which is worth $3,100 in tax savings (31% X $10,000). However, if the $10,000 is a capital expenditure to residential rental property, then the $10,000 is written off over 27-1/2 years which gives an annual deduction of about $360 year. In this scenario the tax savings are
only $112 in the first year and in the subsequent 26-1/2 years ($360 x 31%). In the first year, this amounts to a difference in tax savings of almost $3,000! These tax savings can then be used as an immediate source of down monies for other income-producing properties.

2. CREATES OR INCREASES LOSSES, INCLUDING AN NOL. Rental property losses can offset other income, including your spouse’s income (on a joint return). Fully deductible repairs create or increases rental losses.

EXAMPLE: Your rental property is showing net taxable income of $10,000. In a 31% bracket you would owe $3,100 in taxes. Assume you also have $20,000 of expenditures that you classify as repairs. Consequently, the $10,000 taxable income will now be a net rental loss of $10,000, which can be used to offset your other income (salaries, business income, interest, etc.). Now you have the opposite, $3,000 in tax savings.

NOL - Another part of this advantage is an NOL (Net Operating loss). An “NOL” originates from business losses (including rental property losses) in excess of all of your other income, creating a negative taxable income. The benefit of an NOL is that it can be carried back to recoup past due taxes or carried forward to offset future taxable income (and save taxes). Deductible repairs are business expenses, which increase business losses and an NOL. Thus, the more deductible repairs you have, the higher the NOL For a further discussion of NOL’s (including favorable updates), see Chapter 28.

3. NO CASH OUTLAY WITH LEVERAGE. Because repair expenditures could be leveraged (such as with a rehab loan), such leveraged deductions do
not require the outlay of cash. This is similar to depreciation; thus making repairs part of the *Goldmine* componentizing system.

**Reverse Strategy:** However, there may be times where it is better to classify items as capital improvements instead of deductible repairs. This is discussed in Chapter18-A, part D.

**B. GENERAL GUIDELINES – REPAIRS VS. IMPROVEMENTS**

While the following are not the final say on deciding on a repair versus an improvement, they can be useful guidelines in doing so.

1. **Repairs In General:** Deductible repairs are those that keep the property in an ordinary, efficient operating condition, Reg. 1.162-4. Labor, supplies and incidental repairs are deductible business expenses, Reg. 1.162-1(a). Temporary and incidental expenditures, especially annual expenditures which are intended to last for less than a year, are generally repairs. Included here is maintenance, Reg. 1.263(a)-1(b). IRS pub. 527 lists the following as examples of repairs - Repainting inside or out, fixing gutters or floors, fixing leaks, plastering and replacing broken windows. Minor expenditures in replacing small parts are generally repairs, *Libby & Blouin Ltd*, (1926) 4 BTA 910 (A). Thus, replacing small parts to a heating system may be considered fully deductible repairs, based on these guidelines.

2. **Capital Improvements In General:** These include new additions to a building and other major renovations or construction, IRC 263; *Human Engineering Institute*, TC Memo 1978-45; *LaPoint*, (1990) 94 TC 733. Expenditures to adapt a property to a new or different use are capital, Reg.
1.263(a)-1(b). Capitalization is required for equipment, furniture and fixtures*, if it has a useful life of more than one year, Reg. 1.263(a)-2(a); *Such equipment and appliances are 5-year personal property. Repairs to such equipment should be fully deductible.

C. THERE ARE TAX-REDUCTION STRATEGIES TO CONVERT CAPITAL IMPROVEMENTS INTO FULLY DEDUCTIBLE REPAIRS

The burden is on the taxpayer to prove the classification of items as repairs. In addition, repairs and maintenance deductions are often closely scrutinized by IRS agents. However, dramatic tax savings can frequently be attained by the imaginative structuring of real estate transactions. The area of repairs versus capital improvements is no exception. Expenditures that appear to be “capital” at first glance, may be restructured and documented to be classified as deductible repairs. The next several chapters reveal powerful planning strategies to maximize repairs deductions.

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Primary Strategies To Maximize Repair Deductions

Reference Source (return tab): SAP 7, Part A

This chapter includes the most powerful way to maximize repairs deductions with tax law citations. We will cover the following...

A. PRIMARY STRATEGY I: COMPONENTIZE IMPROVEMENTS INTO REPAIRS WITH THE FOREST-TREE SEGMENTATION METHOD

B. PRIMARY STRATEGY II: USE THE “PREVENT OR CORRECT DAMAGE” DEFENSE [Strategies include real world victories over IRS]

B-1. LARGE DOLLAR AMOUNTS FOR PREVENTING OR CORRECTING DAMAGE STILL CAN BE REPAIRS WITH MORE TAX LAW CITATIONS

C. PRIMARY STRATEGY III: COMBINE I AND II - COMPONENTIZE IMPROVEMENTS INTO REPAIRS WITH “PREVENT OR CORRECT DAMAGE” DEFENSE

D. CAPITAL IMPROVEMENTS THAT COULD HAVE BEEN REPAIRS WITH BETTER PLANNING & DOCUMENTATION

E. SCHEDULE OF DEDUCTIBLE REPAIRS & MAINTENANCE - BLANK AND FILLED-IN FORMATS

F. IRS REPORTING FOR REPAIR DEDUCTIONS WITH AUDIT PROOFING

A. PRIMARY STRATEGY I: COMPONENTIZE IMPROVEMENTS INTO REPAIRS WITH THE FOREST-TREE SEGMENTATION METHOD

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 may lose their nature as repairs if they are part of a general plan of improvement or reconditioning. To accomplish do the following:

1. **Fractionalize.** Segmentize the large expenditures into a larger number of smaller separate repair expense categories with each category backed up by tax law cites documenting it as a repair deduction and each repair is broken down accordingly on the contractor’s invoice.

2. **The invoices 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, “repaint”, “repatch”, “repaper”, “recoat”, “resurface”, “redo”, etc. These have been in the taxpayer's favor in deciding that expenditures were repairs.

   **Avoid** words such as: “new” “lump sum”, "additions", "adding", “construction", "conversion", "extensive", "remodeling", “renovating”, etc. These have generally led to expenditures being capital.

   Be alert that the wording on the invoice should not be deceiving with the intent to falsify information.

**Supporting Tax Law Cites for Fractionalization:** Cobleigh, TC Memo, 1956-261. See also I.M. Cowell, 18 BTA 997 and Joseph Merrick Jones, 24 TC 563, aff’d 242 F2d616 (CA 5, 1957). See also *Federal Income Taxation of Real Estate* by Gerald J. Robinson, Sixth Edition, Volume I, 15.06 [1], Converting Improvement Costs Into Deductible Repairs by “Fractionalization”.

**Goldmine Form to Use:** *Schedule of Deductible Repairs & Maintenance* at the end of this chapter and on the *Renaissance* Goldmine forms disk.
B. PRIMARY STRATEGY II: USE THE “PREVENT OR CORRECT DAMAGE” DEFENSE

Document that the expenditure was to prevent or correct some type of damage and did not (1) materially add to value, or (2) did not substantially prolong life, or (3) did not adapt the property to a different use but brought back the property to its original state or condition. Besides properly worded contracts and invoices (indicating “prevent or correct damage”), you should have as proof, photographs of the damage along with any third party documentation such as appraisal or insurance reports.

VICRORY OVER IRS! REAL WORLD SECENARIO: Costs to correct tenant damage to an apartment - REPAIR. Tax expert and CPA, Peter Cordua, successfully argued this at the IRS examination level. The repair costs did not materially add to the property value, substantially prolong its life or change the property use. The costs only corrected the damage and brought back the property to its original existing state or condition. They had to be done! The tax court reaffirmed that expenditures, that merely restored a damaged property to its original condition, were repairs. Allen, TC Memo, 1998-406.

Supporting Tax Law Cites for Above Scenario:

Painting*, papering and decorating - REPAIR, Rose v. Haverty Furniture Co., 15 F2d 345; Luce Furniture Company (1928) 9 BTA 1413 (A); *IRS Publications 523 & 527.

Cost of carpet used to repair sections that were worn out and needed replacement – REPAIR, George S. Beck, TC Memo.1994-122.

VICRORY OVER IRS! REAL WORLD SECENARIO: Cost of $100,000 to replace wooden foundations with concrete and steel foundations in order to correct termite damage to a property - REPAIR. Tax expert and CPA, Ron


*Noll* successfully argued this. Similar to the last scenario, the costs only corrected the damage and brought back the property to its original existing state or condition. Again, the tax court reaffirmed that expenditures, that merely restored a damaged property to its original condition, were repairs. *Allen*, TC Memo, Ibid.

**NOTE**: The fact that the amount of the costs are substantial in amount does not necessarily mean they are capital improvements. (*American Bemberg Corp.* deducted a million dollars in repairs. *Large Dollar Amounts Still Can Be Repairs*

**Supporting Tax Law Cites for Above Scenario:**

**Mending and resurfacing floors – REPAIR**, *G&R Corp.*, 8 TCM, 970


Supporting strategies for prevent or correct damage:

1. **Refurbish instead of replace.** Techniques that you use to save on improvement costs are also ways to secure full repair deductions. Here, you *refurbish*, instead of replace. Examples are:

<table>
<thead>
<tr>
<th>Proposed Improvement*</th>
<th>Cost Saving Repair</th>
</tr>
</thead>
<tbody>
<tr>
<td>New carpet..................</td>
<td>* Repair, patch, clean, shampoo old carpet; for smells - <em>Odor-Xit</em></td>
</tr>
<tr>
<td>New carpet..................</td>
<td>* Remove old carpet; paint or polyurethane floor</td>
</tr>
<tr>
<td>New drop ceiling..........</td>
<td>* Paint old ceiling tiles and grid work</td>
</tr>
<tr>
<td>New roof.....................</td>
<td>* Silver coating, patching, caulking, roof cement; repair flashing Patching leaks in an existing roof a repair, <em>Pierce Estates</em>, 16TC1020</td>
</tr>
<tr>
<td>New windows...............</td>
<td>* Repair and paint old windows</td>
</tr>
<tr>
<td>New doors...................</td>
<td>* Repair, patch and paint old doors</td>
</tr>
<tr>
<td>New appliances.............</td>
<td>* Repair, clean and paint old appliances</td>
</tr>
<tr>
<td>Replace paneling..........</td>
<td>* Paint over old paneling</td>
</tr>
<tr>
<td>New materials.............</td>
<td>* Used materials, such as used carpeting (see tax tip below **)</td>
</tr>
</tbody>
</table>

**Use the same materials.** Some expenditures, which generally may be considered capital improvements, were considered repairs where the *same*
material was used again. *Thurner*, TC Memo 1/21/52; *Pennock Plantaion Inc.*, TC Memo 10/8/51.

**NOTE:** Let’s not the tax tail wag the financial dog. If an item is too worn out, then replacement, as opposed to refurbishing, may be more economically feasible. This is an investment decision beyond the scope of this publication.

2. **Do preventive maintenance (PM) as a way to save on costs and secure full deductions.** PM is taking care of things before they break down and become a major problem and a substantial cost. Unfortunately, most real estate investors do not employ this powerful management technique. Examples of PM are periodically coating the roof; periodically doing exterior painting; periodically changing wax rings to prevent water leaks; periodically changing heater filters, etc. Such cost-saving maintenance is clearly deductible and not a capital improvement. Supporting tax law cites for PM as a repair are below...

   **The cost of cleaning, sanding and painting - REPAIR,** even though the useful life extends for several years by this maintenance program. Cost of cleaning outer walls of a building are similarly deductible, PLR 1999490003.

   **Large expenses of $270,000 as part of normal, ongoing maintenance - REPAIR,** even though the expenses were large in amount and were done in conjunction with major remodeling. A hotel did this to maintain the first-class status of the hotel, *Jerome Moss*, (1987- CA9) 831, F2d 833, 60 AFTR 2d 87-5910, 87-2 USTC 9590, revg TC Memo 1986-12. An apartment or office building may have to do the same thing.

PM will also keep tenants happier, which increases the likelihood that they will pay on time, stay longer, take better care of the property and not be opposed to reasonable rent increases. (For more info about PM and other excellent management publications, contact *Mr. Landlord*, 1-800-950-2250; www.mrlandlord.com.)

3. **Use the “Section 212” (production of income) argument used in the window-repair scenario.** See below.
**VICTORY OVER IRS! REAL WORLD SCENARIO:** Installation of all new windows in an apartment building to prevent tenants from moving out because of heat loss from old windows (tenants paid their own heat) - REPAIR. This came from someone who was in one of my tax classes a number of years ago. She was a real estate agent and a tax advisor. Unfortunately, I lost contact with her and have no name. But I do remember her defense. She creatively used what I call the “Section 212 argument”, along with the dictionary. Internal Revenue Code Section 212 (“Expenses for production of income”) allows for the “deduction of all the ordinary and necessary expenses paid or incurred for (1) The production or collection of income; or (2) for the management, conservation*, or maintenance of property held for the production of income.” (emphasis added). (See also Regulation 1.212-1). Webster’s Dictionary definition of “conservation” includes these words, “prevention of loss”, “preservation” and “protect”. In this scenario the tenants were threatening to move out unless she replaced the windows for better insulation, less heat loss and lower utility bills. If the tenants move, she loses significant income, unless she installs the new windows. Thus, the sole purpose of the new windows was to “conserve” or “protect” her income and the “prevention of loss”.

*Result: A full repair deduction.* This is a prime example of how astute entrepreneurs can be creative & aggressive when they are in an arbitrary question of fact such as repairs vs. improvements.

**TAX ALERT:** Reg. 1.212-1(n) states that if an item is otherwise capital, then Section 212 will not cause what should be normally a capital expenditure to be a deductible expense. Thus, there was a hole in her argument that was not picked up by the IRS agent. (It happens!) Possibly, she also demonstrated that the windows only brought back the property to its original existing state or condition. Moreover, this situation (which is not a tax court case) had unusual circumstances, which were well documented with written evidence of the tenant complaints. Also, see next.

**Strategy:** Document the above types of expenditures by contracts and invoices, along with any third party documentation such as tenant complaints, photos, appraisals - indicating that the expenditures did not materially add to value, or did not substantially prolong life, or did not adapt the property to a different use.

**VICTORY OVER IRS! ANOTHER WINDOW-REPAIR SCENARIO:** Appraiser, *Harry Schonback* [610-495-5615], was in one of my tax seminars. He
wrote off as repairs $6,000 of brand new *PermaSeal* windows for his small apartment building. Upon audit, his astute argument was that the existing windows were so old that it would have cost more to repair them than to replace them with new ones. At the examination level, the IRS accepted his argument as a full repair deduction. Harry’s appraisal knowledge may have helped here. I assume that in this scenario the IRS agent took the view* (*no pun intended!) that the new windows did not materially add to value or substantially prolong life, or (certainly) did not adapt the property to a different use. They simply brought back the property its original existing state or condition.

**AUDIT RISK WITH PLANNING IDEAS:** On his 1040 Schedule E, Harry categorized the full write-off as “supplies”. Now, $6,000 of “supplies” for a small apartment building could have been a possible red flag, especially on 1040 Schedule E. A less audit-prone classification may have been “*replacing broken windows, which is a repair as per IRS publication 527*”. IRS publication 527 lists “replacing broken windows” as an example of a repair. Another creative planning idea may have been to capitalize just the front windows as an improvement, because as “curb appeal”, they add more to value. The remaining windows are arguably deductible maintenance and just keep the property “*in an ordinarily efficient operating condition*”, as per Reg. 1.162-4. Doing the latter may have eliminated the red flag and also shows discretion on the part of the taxpayer. **REMINDER:** Filing a partnership return (Form 1065), instead of Schedule E, may have eliminated the audit altogether. For more applicable audit proofing techniques that may have prevented the audit altogether, see Chapter 19.

**NOTE:** One would normally conclude that new windows are capital improvements. But the above were situations that were well documented. However, IRS publication 527 lists “replacing broken windows” as an example of a repair. Isn’t installing new windows the equivalent of replacing broken windows? I say it is. Again, we are dealing with a controversial question of fact where taxpayers should structure transactions in their favor.

4. If the expenditures are significant, obtain an appraisal certifying that there is little or no change in value to the property. Here, use a certified or licensed real estate appraiser.
5. If applicable, document that the expenditure was required by law. According to a number of cases, the fact that expenditures are required by law, local ordinance or government authority does not necessarily change what should be an improvement into a deductible repair. However, on IRS audits, I have found this to be a convincing argument to support a repair deduction, because such expenditures made to comply with local building codes do not necessarily materially add to value or appreciably prolong the life of the property. Moreover, there is authority to support this. See RR 73-203; *Commodore, Inc.* (1942) 46 BTA 718 (A). **Maintenance expenses to keep a property safe - REPAIR,** *John A. Schmid*, 10 BTA 1152. These types of costs are deductible maintenance.

6. Fully deduct supplies & materials that have a useful life of less than one year. You can do this even if the useful life extends in part to the next tax year and the supplies or materials are not used up in the year of purchase, Reg. 1.162-3; RR 73-357; *Harold W. Guenther*, TC Memo. 1975-194. Examples are maintenance, cleaning and hardware supplies.

**B-1. LARGE DOLLAR AMOUNTS FOR PREVENTING OR CORRECTING DAMAGE STILL CAN BE REPAIRS WITH MORE TAX LAW CITATIONS**

Just because the cost of the repair is substantial does not bar the deduction for a repair. In the following cases, deductions have been allowed for:

1. Over $46,000 spent to arrest and prevent further damage to building foundation piles caused by unexpected lowering of the water level; *Illinois Merchants Trust Co.* (1926) 4 BTA 103(A).
2. Costs of $108,000 spent for second-hand engines to replace broken down engines on a cargo vessel; Shore, Philip. TC Memo 1959-166, revd on another issue (1961, CA5) 286 F2d 742, 7 AFTR 2d 653, 61-1 USTC ¶ 9230.

3. Expenditures of over $1,000,000 made to repair and prevent cave-ins at a plant which had been erected on a geological fault; American Bemberg Corp. (1948) 10 TC 361, affd (1949, CA6) 177 F2d 200, 38 AFTR 758, 49-2 USTC ¶ 9460.

4. Costs of $12,000 to add layers of insulating material over the roof* of a newly constructed factory building. The new roof just put the building back to its former efficient operating condition; Munroe Land Co. TC Memo 1966-2. (underline emphasis added)

5. Costs of 21,000 to repair a leaking roof*. The sole reason for the repair was to prevent leaks. The property was originally leak-free and the repair merely restored it to that condition; Oberman Mfg Co. (1967) 47 TC 471.

6. Costs of $50,000 to enlarge a reservoir by one-fourth to one-half acre in order to prevent the dam from leaking and thus keep it an ordinary operating condition. The reservoir was drained, soil excavated from the dam, and then replaced with 10,000 cubic yards of clay to seal the dam. Despite being extensive, the expenditures merely restored the capability of retaining water; Evans vs. Comm’r, 557 F.2d 1095.

7. Costs of $270,000 of painting and repapering as part of normal, ongoing maintenance. A hotel did this to maintain the first-class status of the hotel. The costs still were deductible even though they were substantial in

**Strategy:** Even though apparently capital in nature, the underlying rationale for the above repair deductions is to prevent damage and restore the property back to its original condition.

*NOTE:* In a conservative tax climate where “roofing” is generally considered to be a capital improvement, it is encouraging to note that numbers 4 and 5 involved large roofing expenditures that were treated as deductible repairs. In fact, the expenditures in number (4) were considered to be a “new roof”. In gray areas, such as repairs vs. improvements, anything is possible for entrepreneurs with creative minds.

**C. PRIMARY STRATEGY III: COMBINE I AND II - COMPONENTIZE IMPROVEMENTS INTO REPAIRS WITH “PREVENT OR CORRECT DAMAGE” DEFENSE**

Here, you componentize the improvements into smaller expense repair categories each one supported up by tax cites as discussed in Part A. Then you document the prevent or correct damage argument as discussed in Part A. This is a powerful IRS defense, twice over.

**D. CAPITAL IMPROVEMENTS THAT COULD HAVE BEEN REPAIRS WITH BETTER PLANNING & DOCUMENTATION**

1. **Cost of covering an old pine floor with a new oak one - CAPITAL IMPROVEMENT, *G&R Corp.*, 8 TCM, 970.**
**Strategy:** The key word here is “new”. Perhaps rewording the bill and the contract (without falsifying) could have lead to a deductible repair.

**Strategy:** Alternatively, if the new floor is movable with easily removable adhesives, it may qualify for 5-year personal property.

2. Replacing an old brick floor with a new special concrete floor because the old floor was causing accidents involving mechanical equipment. The new floor was smoother. - CAPITAL IMPROVEMENT, *Vanalco*, TC Memo, 1999-265. The Tax Court stated that the change did more than just restore the property to its previous condition. It became more valuable to the company because the new flooring was safer and easier to clean and repair.

**Strategy:** But isn’t “safer” and “easier to clean”, *maintenance*? It was in *John A. Schmid*, (see 8 below). Moreover, new flooring was allowed as a repair in *Knoxville Iron Co.*, TC Memo 1959-54 and *Hudlow, W.C.*, TC Memo 1971-218. Concrete steps replacing wooden footings to allow continued use of the property was also a repair, *Thomas Campbell*, TC Memo, 1973-101.

**AA COMMENT:** Inconsistency! The above taxpayer (*Vanalco*) should appeal this decision with better documentation showing the costs just restored the property back to its preexisting condition.


**Strategies:** (1) Look to *reclassify* real-property capital improvements as 5-year personal property. Here, the exit signs qualify for 5-year
personal property. (2) If feasible, instead of totally replacing the fire escape, repair it - paint, mend, replace parts of it, etc.

**E. SCHEDULE OF DEDUCTIBLE REPAIRS & MAINTENANCE - BLANK AND FILLED-IN FORMATS**

1. **Purpose**: To enable the investor to fully write off expenditures as repairs by segmentizing large expenditures into smaller repairs with the tax law cite supporting every expenditure.

2. **How-to-use**: Separate bills should be obtained for each of the repair or maintenance items listed on this form. Then enter the amount from each bill next to the appropriate repair item on the form. Alternatively, if there is one contractor then one separate invoice can breakdown each repair or maintenance item.

3. **Audit Proof**: Keep this as a backup form, along with this entire module, in the event of an IRS examination. However, here you should also attach your filled-in completed version of this form to your tax return. See part F.

**FORM: Schedule of Deductible Repairs & Maintenance**
(Blank format)

<table>
<thead>
<tr>
<th>Description of Repair or Maintenance Item</th>
<th>Supporting Tax Law Cite for Each Repair or Maintenance Deduction</th>
<th>Invoice Reference</th>
<th>Expense Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Driveway, patching to</td>
<td>Knoxville Iron Co. TC Memo 1959-54</td>
<td></td>
<td>+$</td>
</tr>
<tr>
<td>Description</td>
<td>Citation</td>
<td>Reference</td>
<td></td>
</tr>
<tr>
<td>--------------------------------------------------</td>
<td>--------------------------------------------------------------------------</td>
<td>-----------</td>
<td></td>
</tr>
<tr>
<td>Resurface parking lot</td>
<td>Toledo Home Fed S/L vs. US (1962, DC OH) 203 F, Supp 491</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Painting, cleaning outside</td>
<td>IRS Pubs 523, 527; PLR 1999490003</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Pointing, white washing</td>
<td>City National Bank, TC Memo, 4/23/52</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Foundation piles</td>
<td>Illinois Merchants Trust Co. (1926) 4 BTA 103(A)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Footings, with new cement</td>
<td>Del. Steeplechase &amp; Race Assn., 10/17/50, TCM 893</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Joists, extensive repairs to</td>
<td>Farmers Creamery Corp (1950) 14 TC 879</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Water damage, lining of basement</td>
<td>Midland Empire Packing, 14 TC 635</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>New roofing</td>
<td>Munroe Land Co. TC Memo 1966</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>New roof</td>
<td>Nevia Campbell, TC Summary Opinion 2002-117</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>New roof</td>
<td>Thomas J. Northen, Jr. TC Summary Opinion 2003-113</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Reroofing with same materials</td>
<td>Thurner, TC Memo 1952, 11 TCM 42</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Replacing of roofing sheets</td>
<td>Knoxville Iron Co. TC Memo 1959-54</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Replace broken roof slate; stopping leaks</td>
<td>Knoxville Iron Co. Ibid</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Replace deteriorated roof decking</td>
<td>Oklahoma Co. v US (1966, DC OK) 272 F, Supp 729</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Repair leaking roof</td>
<td>[Oberman Mfg Co. 47 TC 471; Pierce Estates, Inc. 16 TC 1020</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Gutter repairs</td>
<td>IRS Pubs 523, 527; Knoxville Iron Co. Ibid</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Ceilings , extensive repairs to</td>
<td>Farmers Creamery Corp (1950) 14 TC 879</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Ceilings, painting to</td>
<td>RR 62-180; IRS Pubs 523,527; Chesapeake Corp of VA (1951)17 TC 668(A)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Walls, extensive repairs to</td>
<td>Farmers Creamery Corp Ibid</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Walls, new cement</td>
<td>Del. Steeplechase &amp; Race Assn., TC Memo 10/17/50, 9TCM 893</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Plastering walls</td>
<td>[IRS Pub 523, 527; Sturgill Motor Co. TC Memo 1973-281</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Painting walls</td>
<td>RR 62-180; IRS Pubs 523,527; Chesapeake Corp of VA, Ibid</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>Task</td>
<td>Authority</td>
<td></td>
<td></td>
</tr>
<tr>
<td>------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cleaning walls</td>
<td>PLR 1999490003</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Wallpaper</td>
<td>Rose v. Haverty Furniture Co., Ibid.; Markovits, 7/31/52, 11 TCM 823</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Carpet repairs</td>
<td>George S. Beck, TC Memo 1994-122</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Floor mending and resurfacing</td>
<td>G&amp;R Corp., 8 TCM, 970</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Replace flooring</td>
<td>Knoxville Iron Co. TC Memo 1959-54</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Reinforce sagging floors</td>
<td>Regenstein (1954) 121 F Supp 952</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Extensive repairs to floors</td>
<td>Farmers Creamery Corp Ibid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Pouring &amp; finishing concrete floor</td>
<td>Hudlow, TC Memo 1971-218</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other floor repairs</td>
<td>IRS Pubs 523, 527; Farmers Creamery Corp Ibid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Steps, repairs or painting to</td>
<td>Reg. 1.162-4; RR 62-180; IRS Pubs 527; Chesapeake Corp VA</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Concrete steps replacing wooden footing</td>
<td>Campbell, TC Memo, 1973-101</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Replace broken windows</td>
<td>IRS Pub 527; Buckland</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Replace broken glass</td>
<td>Rose v. Haverty Furniture Co., Ibid.; Irs Pub 523</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Replace old window sills</td>
<td>Buckland (1946) 66 F Supp 681, 35 AFTR 161</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Other window repairs</td>
<td>Buckland, Ibid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Plumbing repairs</td>
<td>Rose v. Haverty Furniture Co., 15 F2d 345</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fixing leaks</td>
<td>IRS Pubs 523, 527</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Caulking to prevent leaks</td>
<td>Reg. 1.162-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Heating repairs</td>
<td>Reg. 1.162-4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Electrical repairs</td>
<td>Reg. 1.162-4</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Maintenance** (Including during a general plan of renovation; see Appendix B):
The following are maintenance type items that should be fully deductible as per the following tax law authority: Reg. 1.162-4; Chesapeake Corp of VA, (1951) 17 TC 668(A); Stoeltzing (1959, CA 3) 266 F2d; Moss (1987- CA9) 831, F2d 833, 60 AFTR 2d. This tax law authority supports the maintenance items below, along with any other tax law cites right next to the item.

<table>
<thead>
<tr>
<th>Task</th>
<th>Authority</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cleaning</td>
<td>Grilles Frozen Custard Inc, TCM 1970-73; Jacobson, TC Memo 1983-719; see also above</td>
</tr>
<tr>
<td>Environmental clean-up; lead</td>
<td>RR 98-25; PLR 9411002; see also above</td>
</tr>
<tr>
<td>Item</td>
<td>Reference</td>
</tr>
<tr>
<td>--------------------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Paint removal</td>
<td></td>
</tr>
<tr>
<td>Environmental clean-up; asbestos removal</td>
<td><em>Cinergy,</em> Fed. Claims Ct; see also above</td>
</tr>
<tr>
<td>Environmental clean-up; asbestos encapsulation costs</td>
<td><em>PLR 9411002; see also above</em></td>
</tr>
<tr>
<td>Cleaning supplies</td>
<td>See above</td>
</tr>
<tr>
<td>Decorating</td>
<td><em>Rose v. Haverty Furniture Co., 15 F2d 345; see also above</em></td>
</tr>
<tr>
<td>Equipment Rental</td>
<td>See above</td>
</tr>
<tr>
<td>Exterminating</td>
<td>See above</td>
</tr>
<tr>
<td>Hardware</td>
<td>See above</td>
</tr>
<tr>
<td>Janitorial</td>
<td>See above</td>
</tr>
<tr>
<td>Lawn Care</td>
<td>See above</td>
</tr>
<tr>
<td>“OdorXit” - getting rid of odors</td>
<td>See above</td>
</tr>
<tr>
<td>Sanding</td>
<td><em>PLR 1999490003; see also above</em></td>
</tr>
<tr>
<td>Snow Removal</td>
<td>See above</td>
</tr>
<tr>
<td>Water damage</td>
<td><em>Sturgill Motor Co. TCM 1973-281; Southern Ford Tractor 1958, 833; see also above</em></td>
</tr>
<tr>
<td>Maintenance expenses to keep a property safe</td>
<td><em>John A. Schmid, 10 BTA 1152; see also above</em></td>
</tr>
<tr>
<td>Other: _________________</td>
<td>See above</td>
</tr>
<tr>
<td>Small tools*</td>
<td>See above</td>
</tr>
<tr>
<td>Supplies\materials*, useful life of less than a year</td>
<td>Reg.1.162-3: see also above</td>
</tr>
<tr>
<td>Locks &amp; Keys*</td>
<td>Reg.1.162-3; Reg.1.162-4; see also above</td>
</tr>
<tr>
<td>Fire Protection* (extinguishers, exit signs, etc.)</td>
<td>Reg.1.162-3; Reg.1.162-4; see also above</td>
</tr>
</tbody>
</table>

(*The above items may qualify for a full deduction under Section 179 first-year expensing*)

**Total Repairs & Maintenance**

FORM: **Schedule of Deductible Repairs & Maintenance**

(Filled-in format – residential rental property)
Investor name: **Diversified Property Associates (DPA), LLC**

Property type: **Fourplex**

Property address: **121 Mantua St., Philadelphia, PA. 19148**

Year: **2000**

<table>
<thead>
<tr>
<th>1. Description of Repair or Maintenance Item</th>
<th>2. Supporting Tax Law Cite for Each Repair or Maintenance Deduction</th>
<th>3. Invoice Reference</th>
<th>4. Expense Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repair leaking roof</td>
<td>[Oberman Mfg Co. 47 TC 471; Pierce Estates, Inc. 16 TC 1020]</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>$ + 826</td>
</tr>
<tr>
<td>Extensive repairs to ceilings</td>
<td>Farmers Creamery Corp (1950) 14 TC 879</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+1,680</td>
</tr>
<tr>
<td>Painting to ceilings</td>
<td>RR 62-180; IRS Pubs 523,527; Chesapeake Corp of VA (1951) 17 TC 668(A)</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+2,500</td>
</tr>
<tr>
<td>Walls, extensive repairs to</td>
<td>Farmers Creamery Corp Ibid</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+1,982</td>
</tr>
<tr>
<td>Painting walls</td>
<td>RR 62-180; IRS Pubs 523,527; Chesapeake Corp of VA, Ibid</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+2,500</td>
</tr>
<tr>
<td>Carpet repairs</td>
<td>George S. Beck, TC Memo.1994-122</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+ 810</td>
</tr>
<tr>
<td>Floor mending and resurfacing</td>
<td>G&amp;R Corp., 8 TCM, 970</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+1,888</td>
</tr>
<tr>
<td>Replace broken windows</td>
<td>IRS Pub 527; Buckland</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+2,951</td>
</tr>
<tr>
<td>Heating repairs</td>
<td>Reg. 1.162-4</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+ 509</td>
</tr>
<tr>
<td>Electrical repairs</td>
<td>Reg. 1.162-4</td>
<td>ABM Repairs, LLC Inv. 16251</td>
<td>+1,020</td>
</tr>
</tbody>
</table>

**Maintenance** (Including during a general plan of renovation; see Appendix B): The following are maintenance type items that should be fully deductible as per the following tax law authority: Reg. 1.162-4; Chesapeake Corp of VA, (1951) 17 TC 668(A); Stoeltizing (1959, CA 3) 266 F2d; Moss (1987- CA9) 831, F2d 833, 60 AFTR 2d. This tax law authority supports the maintenance items below, along with any other tax law cites right next to the item.
<table>
<thead>
<tr>
<th>Cleaning</th>
<th>Grilles Frozen Custard Inc, TCM 1970-73; Jacobson, TC Memo 1983-719; see also above</th>
<th>R&amp;S, Inv. 6208</th>
<th>+400</th>
</tr>
</thead>
<tbody>
<tr>
<td>Environmental clean-up; lead paint removal</td>
<td>RR 98-25; PLR 9411002; see also above</td>
<td>R&amp;S, Inv. 6209</td>
<td>+1,635</td>
</tr>
<tr>
<td>Cleaning supplies</td>
<td>See above</td>
<td>R&amp;S, Inv. 6210</td>
<td>+200</td>
</tr>
<tr>
<td>Decorating</td>
<td>Rose v. Haverty Furniture Co., 15 F2d 345; see also above</td>
<td>Marie’s DreesUp</td>
<td>+625</td>
</tr>
<tr>
<td>Equipment Rental</td>
<td>See above</td>
<td>G. Towson, Inv. 125</td>
<td>+200</td>
</tr>
<tr>
<td>Exterminating</td>
<td>See above</td>
<td>Western, Inv. 45302</td>
<td>+500</td>
</tr>
<tr>
<td>Locks &amp; Keys*</td>
<td>Reg.1.162-3; Reg.1.162-4; see also above</td>
<td>Ritter St. Hardware</td>
<td>+200</td>
</tr>
<tr>
<td></td>
<td>(*The above items may qualify for a full deduction under Section 179 first-year expensing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Total Repairs &amp; Maintenance</strong></td>
<td></td>
<td></td>
<td>= $ 20,426</td>
</tr>
</tbody>
</table>

Reference Source (return tab): SAP 7, part A

F. IRS REPORTING FOR REPAIR DEDUCTIONS WITH AUDIT PROOFING

Reference Source (return tab): SAP 7, part B

Where to claim the deduction and where to attach this form:
Claim repairs as an operating expense on the applicable IRS rental property schedule (see below). Attach the above form behind the IRS rental property schedule (preferably IRS form 1065). By using this form, you are segmentizing and therefore showing smaller amounts of “repairs” or “maintenance” with meticulous detail, plus the tax law cites that support each deduction.

IRS Schedule E. On Schedule E, there is a line for repairs, which at the present time is line 14. Insert the total repairs on line 14 and clearly insert “See attached backup schedule to repairs” – which you insert either next to
or under or very close to line 14. Then attach the completed repair/maintenance form right behind Schedule E.

**ALERT**: Schedule E is more audit-prone, not user-friendly and therefore not at all recommended. Use IRS form 1065; see next.

**IRS Form 1065.** On form 1065, page 1, at the present time, line 11 is for Repairs and maintenance. This line is for repairs and maintenance that are not related to rental properties; or are common to all of the properties, not any one particular property. If the repairs are common to all properties, then Insert the total repairs on line 11 and clearly insert “See attached backup schedule to repairs” – which you insert either next to or under or very close to line 11. Then attach the completed repair/maintenance form right behind IRS form 1065.

**IRS Form 8825 supporting form 1065.** On the other hand, for any repairs that are particular to a property or properties, they are properly reported on IRS form 8825 (*Rental Real Estate and Expenses of a Partnership or an S Corporation*). Form 8825 is a supporting schedule to form 1065 and has a line for repairs for each property which at the present time is line 10. Here put the total repairs on line 10 and clearly insert “See attached backup schedule to repairs” – which you insert either next to or under or very close to line 10. Attach the completed repair/maintenance form right behind IRS Schedule 8825.

**NOTE:** IRS form 1065 is less audit prone than Schedule E and more user-friendly. It therefore is highly recommended, along with an LLC for personal liability protection.

Reference Source (return tab): **SAP 7, Part B**
In this chapter we will cover...

**A. FULLY DEDUCT EXPENDITURES FOR THE HANDICAPPED (REMOVAL OF ARCHITECTURAL BARRIERS PER IRC 190)**

**B. ENVIRONMENTAL-REMEDICATION OR CLEANUP COSTS**

**C. LOOK TO RECLASSIFY REAL-PROPERTY CAPITAL IMPROVEMENTS AS 5-YEAR PERSONAL PROPERTY**

**D. IF YOU DO NOT NEED REPAIR DEDUCTIONS, THEN CAPITALIZE THE EXPENDITURES**

**E. TAX-REDUCTION & AUDIT PROOFING FORMS RELATED TO REPAIR DEDUCTIONS**

FORM: *Schedule of Expenditures for The Handicapped*

FORM: *Schedule of Real Property Capital Improvements*

A. FULLY DEDUCT EXPENDITURES FOR THE HANDICAPPED (REMOVAL OF ARCHITECTURAL BARRIERS PER IRC 190)
1. **Do it:** If you will be doing renovations to a property, claim a **full deduction** (up to certain limits) for qualifying expenditures for the handicapped.

2. **Type Expenses:** These are expenses to modify a building to accommodate handicapped and elderly persons. They involve the installation of ramps, widening of doorways and lavatories to allow for wheelchairs and other such improvements to accommodate the handicapped or elderly as per the *Americans With Disabilities Act (ADA)*.

4. **Fully expense up to $15,000 with no argument:** If the improvements meet the requirements of this provision, you can make an election to fully expense up to $15,000 (per year) of these types of costs. You can deduct these qualifying expenditures (up to $15,000), regardless if they materially add to value, appreciably prolong life or change its use. That is, there is **no argument** as to their full deductibility, if you meet the tests of this provision, IRC 190. Above these limits, you follow the repair deduction strategies of Chapter 18.

5. **Election:** You make the election just by claiming the deduction on a timely filed return, including extensions. Past this period the election is irrevocable. Just take the deduction on your rental property tax schedule, and list as “*Expense incurred in the removal of architectural barriers deducted under Internal Revenue Code Section 190*”.......$__xxx__, tax year 20____. Make sure you have adequate records to support the deduction. Invoices and contracts should clearly spell out the nature of the expenses in accordance with this provision.

6. **Goldmine Form to Use:** *Schedule of Expenditures for The Handicapped* at the end of this chapter and on the *Renaissance* Goldmine forms disk.

7. **Strategy:** **Double the deduction to $30,000.** If you straddle these expenses from the end of one year into the beginning of the next year, you
can increase your deduction limit to $30,000 ($15,000 x 2 years). Any such expenditures beyond these limits are subject to the previously discussed rules of deductible repairs versus capitalization. Above these limits you follow the repair deduction strategies of Chapter 18.

8. Credit instead of deduction: Under IRC 44, eligible small businesses (including rental property owners) can alternatively claim a dollar-for-dollar tax credit for these types of expenses. If you claim the credit, you cannot also claim a deduction for the same expenditures discussed above. For more about the credit see Chapter 21-A.

B. ENVIRONMENTAL-REMEDIATION OR CLEANUP COSTS

1. Should be deductible: Most tax experts (including noted author, Gerald Robinson, Esq.) agree that such costs only restore a property to its original condition and do not materially add to value or substantially prolong life. Therefore, they should be fully deductible repairs.

2. IRS inconsistent position still lends overall support: However, the IRS has initially ruled that the costs for the removal of asbestos are not deductible as a repair, but must be capitalized, PLR 9240004. In a subsequent ruling, the IRS stated that asbestos encapsulation costs are currently deductible, PLR 9411002. This ruling is further supported by Cinergy Corp., US Court of Federal Claims, 3/10/03. In RR 98-25 not only did the IRS allow a full deduction for the cost of removing, cleaning and disposing of old underground storage tanks, they also allowed as a full current deduction the cost of acquiring, installing and filling the new underground storage tanks. The IRS’s rationale in allowing the deduction is that the new tanks had no remaining useful life and were like materials and supplies.
AA COMMENT: Although we favor the ruling, the IRS’s rationale is questionable. It certainly can be argued that the new tanks are capital equipment with a useful life of more than one year. Perhaps the IRS is trying to make up with its initial harsh ruling on asbestos removal (PLR 9240004). It now appears that the IRS has taken the correct position in that more of these types of costs should be fully deductible. They were dead wrong to begin with. Such costs are really clean-up expenses which are deductible repairs. Today, we have the clean-up or encapsulating of lead-based paint. I say, repair!

3. IRS Private Letter Rulings are not law. PLR’s only pertain to the individual who personally requested the ruling from the IRS. Other taxpayers do not have to abide by them. Plus, in most cases requesting a PLR from the IRS is very imprudent. (It’s like asking the opposing team if it’s all right to do a certain play.) Certainly in the first ruling above (9240004), it was unwise to request the ruling in light of the fact that tax experts (such as Gerald J. Robinson) agree that such clean-up costs are fully deductible repairs. Moreover, even the IRS eased up on this issue in the above later rulings (PLR 9411002 and RR 98-25).

AA COMMENT: The above again demonstrates the inconsistency of this issue in going both ways - improvement or repair? This an area where entrepreneurs can (and should) be aggressive & creative.

C. LOOK TO RECLASSIFY REAL-PROPERTY CAPITAL IMPROVEMENTS AS 5-YEAR PERSONAL PROPERTY

1. Look to reclassify real-property capital improvements as 5-year personal property. Use componentizing for allocating 5-year property and maximizing depreciation deductions as discussed in Chapter 12. A 5-year write-is may not be as good as a fully deductible repair, it is but much better than the slower 27-1/2 or 39 years for real property capital improvements.
2. Carefully examine the underlying documentation (such as invoices) for 5-year personal property with larger depreciation deductions. Back when I was in tax practice, I was preparing a partnership return for investment properties. When I received the trial balance from the bookkeeper, I noticed that under the asset category there were “capital improvements of $10,000”. However, when I examined the underlying documentation, I found out that most of the so-called capital improvements were for appliances, cabinets, shelves and other fixtures that should be classified as 5-year personal property, not slower depreciable real property. The rest were minor expenditures that we fully deducted as repairs.

D. IF YOU DO NOT NEED REPAIR DEDUCTIONS, THEN CAPITALIZE THE EXPENDITURES

1. Three scenarios to do so: There are at least three situations, where classifying expenditures as capital improvement expenditures instead of repairs are beneficial to you, the investor. They are:

   (a) If you are in a low bracket or loss situation and do not need the additional deductions. Included here is being subject to passive loss limits on rental property losses and/or not being eligible for an NOL per ch.28. Here, treat the expenditures as capital improvements and depreciate them accordingly.

   (b) If you need to qualify for rehabilitation tax credits from real property improvements to older or historic buildings, IRC 47. (See Chapter 20). Here the needed qualification will come from capital improvements and not repairs.

   (c) If the property is a personal residence (first or second homes). Here, capital improvements can be added to basis which in turn reduces capital gain. Increasing basis also would increase depreciations deductions if the home were
converted to a rental property or part of the home used for business, such as home office. On the other hand, repairs to a personal residence, including a second home, provide no tax benefit as they are not deductible at all.

2. **Reverse Strategy**: In these scenarios you should document that the expenditures are capital improvements which materially add to the value of the property, or appreciably prolong its life, or change its use. The planning strategies to do this are essentially the *opposite* of those to classify expenditures as deductible repairs.

4. **Invoices should be worded as “capital improvements”**. Use such words as: “new” “lump sum”, "additions", "adding", “construction", "conversion", "extensive", "remodeling", “renovating”, etc. These have generally led to expenditures being capital. **Avoid** words such as: “repairs”, "prevent damage", “patch”, "temporary", “incidental", "minor", “fix”, “piecemeal", "annual", "less than a year", "decorating", "painting", "small", etc.

Be alert that the wording on the invoice should not be deceiving with the intent to falsify information.

5. **Goldmine Form to Use**: *Schedule of Real Property Capital Improvements* at the end of this chapter and on the Renaissance Goldmine forms disk.

**NOTE**: The above sounds like you are not being consistent and switching from one side to another. Well the two-faced IRS has done the same thing and will argue for *repairs* and *not* improvements. This will naturally happen when such a reversal is in the IRS’s favor such as in the above three scenarios. As a taxpayer, you have the right to do the same.

**Ron Noll Victory Against “Two-Face” IRS**: Ron Noll’s client treated expenditures as capital improvements in order to qualify for tax credits from rehabilitation improvements to an older building. Because in this scenario the dollar-for-dollar tax credit was more valuable than the repair deduction, the IRS argued for repairs. However, Ron proved that the rehab expenditures were...
capital, not repairs. About this Ron says, “The IRS’s goal is to extract money from the taxpayer during the audit and not to do their things on a consistent basis. However, it is this very inconsistency that has also backfired in the IRS’s face. The way the IRS can talk out of two sides of their mouth, so can taxpayers and their advisors. That is, the arguments that IRS will use to seek repair classification are the very same ones that taxpayers could also use when the IRS wants to seek improvement classification. This an area where you should be aggressive!”

E. TAX-REDUCTION & AUDIT PROOFING FORMS RELATED TO REPAIR DEDUCTIONS

FORM: Schedule of Expenditures for The Handicapped

{Guidance on acceptable standards for the elderly and handicapped}

(Blank format)

[Use this form as per the discussion in part A of this chapter]

Year:__________ 20

Investor name:_____________________________________________________

Property type:________________________________________________________

Property address:________________________________________________________________

<table>
<thead>
<tr>
<th>Type Expense</th>
<th>Requirements</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Grading</td>
<td>The ground should be graded to attain a level with a normal entrance to make the facility accessible to individuals with physical disabilities..</td>
<td>$+__________</td>
</tr>
<tr>
<td>2) Walks</td>
<td>A public walk should be at least 48” wide and have a gradient of no more than 5%. A walk should have a continuing common surface (not interrupted by steps or abrupt changes in level). A walk or driveway should have a nonslip surface.................................</td>
<td>$+</td>
</tr>
</tbody>
</table>
3) Parking lots  At least one space that is accessible and approximate to the facility must be set aside and designated for the handicapped. The space must be open to one side to allow wheelchair access. For head-on parking, the space must be at least 12 ft. wide. $+__________

4) Ramps  A ramp should not have a slope greater than a 1” rise in 12”. There must be a handrail 32” in height. A ramp should have a non-slip surface. A ramp should have a level surface at the top and bottom (if a door swings into the platform, the platform should be at least 5’ X 5’). A ramp should have level platforms at least every 30’. A curb ramp should be provided at every intersection (the ramp should be 4’ wide with transition between two surfaces and a non-slip surface) $+__________

5) Entrances  A building should have at least one primary entrance wheelchair accessible and on a level accessible to an elevator $+__________

6) Doors and doorways  A door should have an opening of at least 32”. The floor inside and outside of the doorway should be level for at least 5’ from the door in the direction the door swings and must extend at least 1’ past the opening side of the door way. The threshold should be level with the floor. The door closer should not impair the use of the door by someone who is handicapped $+__________

7) Stairs  Stairs should have handrails at least 32” from the tread at the face of the riser. Steps should not have risers exceeding 7” $+__________

8) Floors  Floors should have a non-slip surface $+__________

Equals:  Total Handicapped Expenditures $=__________

FORM:  Schedule of Real Property Capital Improvements
{Depreciable over 27-1/2 or 39 yrs.}

(Blank format - for internal use only)

[Use this form when you do not currently need repair deductions as per the reasons discussed in part D of this chapter]

Year:__________20
<table>
<thead>
<tr>
<th>Description of Capital Improvement Item</th>
<th>Supporting Tax Law Cite for Each Capital Improvement</th>
<th>Invoice Reference*</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Outside:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Additions to a building</td>
<td>IRC 263(a)(1)</td>
<td></td>
<td>$+</td>
</tr>
<tr>
<td>2. Driveway replacement</td>
<td>Raymond Jones, (1956) 25 TC 1100</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>3. Drainage system, installation</td>
<td>Mt. Morris Drive-In Theatre (1955) 25 TC 272</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td><strong>B. Foundations</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Foundation piles</td>
<td>California Casket Co., (1952) 19 TC 32</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td><strong>C. Roofing:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. A new roof</td>
<td>Odom, TC Memo 1982-531</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>8. Replacing roof</td>
<td>Craig, 7/29/48, 7TCM 532; Pierce Est. 16 TC 1020</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>9. Replacing part of roof</td>
<td>Mountain State Steel Foundation TCM 1959-59</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>11. Reinforcing beams supporting a roof</td>
<td>Levy, TC Memo 3/9/53, 12 TCM</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td><strong>D. Ceilings</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Ceilings</td>
<td>Hubble, 3/17/54, DC-MI, 48 AFTR 1359, 54-1</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>13. Other</td>
<td>IRC 263(a)(1)</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td><strong>E. Walls:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. Walls, replace cracked wall with new wall</td>
<td>Stewart Supply Co., TCM 1963</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td>15. Walls, replaster</td>
<td>Knoxville Iron Co. TC Memo 1959-54</td>
<td></td>
<td>+</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>---</td>
<td>---</td>
<td>---</td>
<td></td>
</tr>
<tr>
<td>17. Brick up windows to strengthen wall</td>
<td>Marble &amp; Shattuck Chair, 1930, CA6</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>F. Flooring:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>18. Floor resurfacing</td>
<td>Knoxville Iron Co. TC Memo 1959-54</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>19. Replace flooring</td>
<td>Honigman (1971) 55 TC 1067; Knoxville Iron Co</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>20. Replace old brick floor with new concrete floor</td>
<td>Vanalco, TCM, 1999-265</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>22. Other floor repairs</td>
<td>Harder, Amsterdam Theatres Corp, (1931) 24 BTA</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>G. Steps:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>24. New steps</td>
<td>IRC 263(a)(1)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>H. Windows:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>25. Brick up windows to strengthen a wall</td>
<td>Marble &amp; Shattuck Chair Co., Ibid</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>26. Window repairing</td>
<td>Pryor, TC Memo 1954-60</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>I. Plumbing\Heating:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>27. Plumbing</td>
<td>Hubble, Ibid; Herman Barron, TC Memo 1963-315</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>29. Heating system, new</td>
<td>Clarence Boddie, TC Memo 1961-72</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>J. Electrical:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>30. Electrical</td>
<td>Herman Barron, Ibid; West VA. Steel Corp (1960) 34TC 851</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td><strong>K. Repairs incurred during and part of a major renovation:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>31. Painting</td>
<td>Pryor, TC Memo 1954-60; Harder, TC Memo 1958-97; Hubble</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>34. Fixing, patching, decorating, etc.</td>
<td>IRC 263(a)(1)</td>
<td>+</td>
<td></td>
</tr>
<tr>
<td>35. Other:</td>
<td>IRC 263(a)(1)</td>
<td>+</td>
<td></td>
</tr>
</tbody>
</table>
### L. Other Capital Improvements:

<table>
<thead>
<tr>
<th>Description</th>
<th>Reference</th>
<th>Note</th>
</tr>
</thead>
<tbody>
<tr>
<td>35. Environmental clean-up</td>
<td>PLR 9240004</td>
<td></td>
</tr>
<tr>
<td>36. Water damage</td>
<td>Universal Mills, TC Memo 11/26/48, 7 TCM 886</td>
<td></td>
</tr>
<tr>
<td>37. Other major renovations or construction</td>
<td>IRC 263(a)(1)</td>
<td></td>
</tr>
</tbody>
</table>

### M. Expenditures to adapt property to different use [Reg. 1.263(a)-1(b)], List them:

<table>
<thead>
<tr>
<th>Description</th>
<th>Reference</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
</tbody>
</table>

TOTAL CAPITAL IMPROVEMENTS (IRS Form 4562, Line 19h or 19i) $=

[*Note: For invoice reference, use the same invoice for each general category – Outside, Foundations, Roofing, Ceilings, etc, per the above.*]

Reference Source (return tab): **SAP 7, Part C**
**18-B**

**Repair Deductions**  
Special Situations & Strategies

Reference Source (return tab): **SAP 7, Part D**

In this chapter we will cover...

<table>
<thead>
<tr>
<th><strong>A. REPAIRS INCIDENTAL TO MAJOR RENOVATIONS</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>B. EXPENDITURES TO PUT A PROPERTY INTO AN ORDINARY OPERATING CONDITION (CAPITAL) VS. EXPENDITURES TO KEEP A PROPERTY IN SUCH CONDITION (REPAIR)</strong></td>
</tr>
<tr>
<td><strong>C. AMOUNT OF EXPENDITURES IN COMPARISON TO THE COST OF THE PROPERTY</strong></td>
</tr>
<tr>
<td><strong>D. DO NOT BE ALARMED ABOUT “INDOPCO” ABOUT SUPPOSEDLY TIGHTENING THE RULES TOWARD CAPITALIZATION</strong></td>
</tr>
</tbody>
</table>

**A. REPAIRS INCIDENTAL TO MAJOR RENOVATIONS**

Incidental repairs which keep property in an ordinarily efficient operating condition are usually deductible. However, there are a number of cases that have held that such repairs, incidental to a general plan of major renovation, must be capitalized. Examples have been - carting refuse, incidental repairs, mending a door, patching plaster, clearing ice and rubbish. (Comment: Unfair!) However, there are numerous cases where such repairs, done at the same time as major renovations, were considered to be deductible repairs, *Markovits*, TC Memo, 7/31/52, 11 TCM 823; *Universal Mills*, TC Memo 11/26/48, 7 TCM 886; *George Kaonis*, TC Memo 1978-184. Maintenance was deductible when it was incurred during a general plan of major

**Strategy 1:** In this situation, to help ensure full deductions, separate the obvious major improvements from the smaller repairs as if they were two different and separate jobs. Do this with separate invoices and contracts. This is supported by the tax court where the costs of remodeling law offices might have been deductible repairs had they been incurred separately, *Charles Bane*, TC Memo 1971-31.

**Strategy 2:** For more deductions you can componentize the improvements into smaller repairs as per Chapter 18, Primary Strategy 1.

**Example:** A contractor installs a new central air conditioning system in your rental property and at the same time has done some minor repairs & maintenance to the heater. You should have the contractor give you two bills; one for the central air conditioning system (which probably would be considered a capital expenditure), and the other heater repairs (which could be considered a repair deduction). By having two separate invoices, you can sustain the burden of proof for at least expensing the repairs to the heater. This would especially be true if you could document that the two separate jobs were coincidentally performed at the same time. If the contractor can do the air conditioning system on a piecemeal basis over more than one year, you may be able to componentize the job into deductible repairs as per Chapter 18, Primary Strategy 1.

**B. EXPENDITURES TO PUT A PROPERTY INTO AN ORDINARY OPERATING CONDITION (CAPITAL) VS. EXPENDITURES TO KEEP A PROPERTY IN SUCH CONDITION (REPAIR)**
According to some case law, there is a theory that expenditures to put property into an ordinarily efficient operating condition are capital improvements, but those that keep the property in such condition are deducible repairs or maintenance. Expenditures to put property into an ordinary efficient operating condition are generally made upon acquisition when the property requires substantial rehabilitation before it can be made into a safe, habitable condition. The question is, what is the cut-off date between expenditures to put property into an ordinary efficient condition (capital improvements), as opposed to expenditures to keep property in this condition (repairs)? One date could be when the property is ready to rent. Under this theory, expenditures up to the point the property is ready for rental are capital, and expenditures thereafter are repairs.

Two strategies to convert expenditures to put a property in ordinary operating condition (capital) > into expenditures to keep property in such condition (repair):

**Strategy 1:** If applicable, obtain a certificate of occupancy (“CO”) as soon as possible when rehabbing a newly acquired property. This is because some practitioners take the position that this cut-off date* should be the date that the certificate of occupancy (“CO”) is issued. Frequently, this date is earlier than when the property is ready to rent. Therefore, under this argument, more expenditures could be classified as fully deducible repairs.

**Strategy 2:** Componentize the improvements into smaller repairs as per Chapter 18, Primary Strategy 1.

**C. AMOUNT OF EXPENDITURES IN COMPARISON TO THE COST OF THE PROPERTY**

Sometimes IRS agents and the tax courts will do a percentage comparison of the amount of the expenditures to the cost of the property. If the percentage
is very high, they will attempt to deny repair deductions. Thus, expenditures that were almost twice the cost of a non-livable building were capital improvements, *Stoeltizing v. Comm’r*, Ibid. However, in this same case maintenance was deductible even though it was incurred during a general plan of major renovation. Moreover, in *Buckland* the tax court allowed as deductible repairs, expenditures that equaled 35% of the building cost. [*Buckland*, 1946, 66 F Supp 681, 35 AFTR 161.]

**Strategies:**

1. **Separate capital improvements** to *put* a property in operating condition vs. repairs that *keep* a property in operating condition as Chapter 18, primary strategy II.

2. **Clearly separate any repairs or maintenance** incurred during a general plan of major renovation as per strategy 1 of part D of this chapter.

3. **Componentize the improvements into smaller repairs** as per Chapter 18, Primary Strategy 1.

4. **Incur the expenditures in more than one year** and thus have a smaller amount each year (if practical). If the IRS looks at just one year, there will be a lower percentage of expenditures for that year compared to the building cost.

5. **Instead of buying a cheap “junker” that needs extensive work, pay more for a property that needs less work.** Here, you will have a lower ratio of repairs to the building cost. From a practical investment viewpoint, this has often worked out for me. In this scenario, you have a lot less aggravation by doing a lot less work. Any work needed is often just “cosmetic” work, which is more likely to be considered deductible repairs.
(Of course, this is an *investment* decision beyond the scope of this publication.)

**D. DO NOT BE ALARMED ABOUT “INDOPCO” ABOUT SUPPOSEDLY TIGHTENING THE RULES TOWARD CAPITALIZATION**

*INDOPCO* is a Supreme Court decision requiring capitalization of expenditures incurred in a corporate takeover, because they created benefits beyond the year (*INDOPCO*, Inc. v. Comm’r, 112 S. 1039). Some conservative tax practitioners may erroneously interpret this decision as a tightening up of the rules in favor of capitalization, requiring certain repairs to be capital improvements. However, in Revenue Rulings 92-80 and 94-12, the IRS has backed away from *INDOPCO* and does not make this rigid interpretation. In effect, the Supreme court decision is just a reiteration of Regulation 1.162-4 (which is not clear to begin with). Moreover, *INDOPCO* did not involve *real estate* expenditures. So we are basically back to this same old controversy of repairs vs. improvements and we should basically ignore *INDOPCO* and follow the Goldmine strategies.

**Reference Source (return tab): SAP 7, Part D**

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you
are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
IRS Audit-Proofing Strategies For Fully Deducting Repairs

A. AUDIT RISK: Claiming a large amount of deductible repairs could create a possible IRS red flag, especially on Form 1040-Schedule E.

B. AUDIT-REDUCTION STRATEGIES: Here are some:

1. Avoid Schedule 1040-E altogether and file a partnership return (Form 1065). See Chapter 5 for a further discussion of LLC-partnerships. If you do this, you should still adhere to the following planning recommendations.

2. Avoid using round, round numbers such as "$1,000". Instead use $998 or $1,002, etc.

3. Avoid large round amounts in one expense category, especially “Repairs”. Example: “Repairs....$10,000”. Avoid this like the plague!

4. Only use "Miscellaneous" for a small amount, generally under $50. Any larger amounts should be categorized using the Goldmine schedule below.

5. Use the special Goldmine form and do a breakdown of repairs into more expense categories, Form Schedule of Deductible Repairs & Maintenance or a modification of it (at the end of Chapter 18 and on the Renaissance Goldmine
forms disk). Attach this form behind the IRS rental property schedule. By using this form you are segmentizing and thus showing smaller amounts of “repairs”, “maintenance” or “supplies” with meticulous detail, plus the tax law cites that supports each deduction. There is also a filled-in sample at the end of Chapter 18.

6. Don’t overdo it and be piggish. As discussed in Section 17, there are some large substantial items that should be classified as capital improvements. Also keep in mind that some capital improvements are 5-year personal property as discussed in Chapter 18-A, Part C. Also, you cannot deduct your own labor; so don’t.

7. Attached explanations, descriptions with tax law citations. For example, in the second window-repair scenario (Harry) of Chapter 18, the recommended window-repair description was “replacing broken windows, which is a repair as per IRS publication 527”.

Reference Source (return tab): SAP 7, Part E

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
19-A

How To Componentize Improvements As Deducible Repairs For Faster & Larger Write-Offs

A Case Study With Filled-In Forms

Reference Source (return tab): SAP 7

THE FOREST-TREE SEGMENTATION METHOD: 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 done separately. Otherwise they will lose their nature as repairs if they are part of a general plan of improvement or reconditioning. You therefore need to componentize or fractionalize the large expenditures into a larger number of smaller repair categories. Do this with separate invoices for each job. This is what the tax court said in Cobleigh, TC Memo, 1956-261. See also I.M. Cowell, 18 BTA 997 and Joseph Merrick Jones, 24 TC 563, afford 242 F2d616 (CA 5, 1957).

CASE STUDY EXAMPLE: Diversified Property Associates (DPA), LLC will be doing a renovation to three 2-bedroom apartments in one of their existing rental properties. The apartments recently became vacant and this is an opportune time to do this. By “modernizing” the apartments, DPA will not only receive considerably more rent and enhance value, but also will attract better qualified tenants. While this is being done, other necessary repairs will also be accomplished. The renovation will entail redoing the walls, floors, ceilings, windows, kitchens, bathrooms and any other necessary repairs.
More specifically, included here will be any necessary gutting out, surface preparation, spackling & taping, extensive repairs to the floors, ceilings and to some of the carpets; otherwise - new carpets. Also, there will be lead paint removal, patching part of a leaky roof, heating repairs, broken window repairs or replacement, new bathroom fixtures, new kitchen appliances and fixtures, new light fixtures, some electrical work (such as new receptacles and switches), equipment rental, painting, decorating, cleaning, exterminating and other odd ball repairs such as replacing the hardware on doors, closets and new locks. The total cost of all of this will be $38,250.

The above cost is split into three major tax categories:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Deductible repairs &amp; maintenance</td>
<td>$20,426</td>
</tr>
<tr>
<td>(2) Five-year personal property</td>
<td>10,000</td>
</tr>
<tr>
<td>(3) Capital improvements (new bathroom fixtures, flooring,</td>
<td></td>
</tr>
<tr>
<td>tile &amp; related plumbing)</td>
<td>7,824</td>
</tr>
</tbody>
</table>

Total Expenditures For This Rehab........ $38,250

Result: Because of this power of componentizing of the total $38,250, DPA will:

- Fully deduct as repairs, $20,426 which is segmentized or fractionalize into 17 separate, smaller repair or maintenance items, as per the attached form. (There is a separate bill for each of these 17 items)

- Write off of $10,000 personal property* in only 5 years. These are componentized into 15 personal property items, as per the attached form.

- Will treat as capital improvements* only $7,824 (to be depreciated over 27-/12 years). These are componentized into 12 items, as per the attached form.
*TAX REMINDER:* Keep in mind that if any of the above capital items (personal property and real property improvements) must be replaced before the end of the recovery period, then the remaining basis can be **fully written off.** Again, this is because of the detailed componentizing per the attached forms.

**NOTE:** You may be thinking why not treat at least some of the above capital improvements of $7,824 as deductible repairs, especially with the attached **component breakdown?** With the many planning strategies in *Goldmine* Section 18, we may be able to. But in this scenario we will not. **Reason:** There is something in prudent tax planning known as The "Pig Theory" > *Little Pigs Get Fed, Large Hogs Get Slaughtered.* That is, don’t overdo it. By capitalizing some of these expenditures, you are showing that you have acted discretely. (Afterall, out of $38,250 we are fully deducting $20,426 and $10,000 as personal property depreciated over only 5 years.) Using these forms, you have systematically provided a breakdown with meticulous attention to detail along with tax law cites.

By doing all of this (including capitalizing certain items) you have built an excellent defense against the IRS. Plus, if any of the above capital items must be replaced before the end of the recovery period, then the remaining basis can be fully written off, as per the Goldmine strategies.

**TAX PLANNING STRATEGIES:**

1. Obtain *separate* bills for each of the 17 repairs items listed on the form.

2. Obtain *separate* bills for each of the 5 general categories of personal property items, namely: (A) The three gas ranges, (B) The three refrigerators, (C) The three sets of carpeting, (D) The three sets of cabinets and (E) The three sets of light fixtures.
3. To be consistent, also obtained *separate* bills for each of the 4 general categories of capital improvement items, namely: (A) The three sinks\vanities, (B) The three tub\shower kits, (C) The three toilets and (D) The three sets of wall tile\flooring.

**Schedule of Deductible Repairs And Maintenance**

{Attach this schedule behind IRS rental property schedule such as 1040 Schedule E or the more preferred Partnership 1065}

<table>
<thead>
<tr>
<th>Description of Repair or Maintenance Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Repair a leaking roof [Oberman Mfg Co.; Pierce Estates]</td>
<td>$ 826</td>
</tr>
<tr>
<td>2. Ceilings, extensive repairs [Farmers Creamery Corp]</td>
<td>1,680</td>
</tr>
<tr>
<td>3. Painting to ceilings [RR 62-180; IRS Pubs 523, 527]</td>
<td>2,500</td>
</tr>
<tr>
<td>4. Walls, extensive repairs to [Farmers Creamery Corp]</td>
<td>1,982</td>
</tr>
<tr>
<td>5. Painting to walls [RR 62-180; IRS Pubs 523, 527]</td>
<td>2,500</td>
</tr>
<tr>
<td>6. Floor mending\resurfacing [G&amp;R Corp., 8 TCM, 970]</td>
<td>1,888</td>
</tr>
<tr>
<td>8. Replace broken windows [IRS Pub 527; Buckland]</td>
<td>2,951</td>
</tr>
<tr>
<td>11. Lead paint removal [RR 98-25; PLR 9411002]</td>
<td>1,635</td>
</tr>
<tr>
<td>SubTotal</td>
<td>$18,301</td>
</tr>
</tbody>
</table>

**Maintenance: (Including during a general plan of renovation)** (Chesapeake Corp of VA.; Stoeltizing; Moss)

<table>
<thead>
<tr>
<th>Description of Repair or Maintenance Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>12. Cleaning [Grilles Frozen Custard Inc; Jacobson ]....</td>
<td>400</td>
</tr>
<tr>
<td>13. Cleaning supplies [Reg.1.162-3; Reg.1.162-4]......................</td>
<td>200</td>
</tr>
<tr>
<td>15. Equipment Rental [Reg.1.162-3; Reg.1.162-4].......................</td>
<td>200</td>
</tr>
<tr>
<td>16. Exterminating [Reg.1.162-3; Reg.1.162-4]</td>
<td>500</td>
</tr>
<tr>
<td>17. Locks &amp; keys [Reg.1.162-3; Reg.1.162-4]</td>
<td>200</td>
</tr>
</tbody>
</table>
NOTE: Detailed Back-Up of above Schedule of Deductible Repairs & Maintenance is in the back of this chapter.

### Schedule of 5-Year Personal Property

*Back Up Schedule Only. Do Not File With IRS*

<table>
<thead>
<tr>
<th>Description of Personal Property Item</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Gas Ranges:</strong></td>
<td></td>
</tr>
<tr>
<td>1. Gas range (Apt. 10) [Regulation 1.48-1(c)]</td>
<td>$465</td>
</tr>
<tr>
<td>2. Gas range (Apt. 21) [Regulation 1.48-1(c)]</td>
<td>465</td>
</tr>
<tr>
<td>3. Gas range (Apt. 29) [Regulation 1.48-1(c)]</td>
<td>470</td>
</tr>
<tr>
<td><strong>B. Refrigerators:</strong></td>
<td></td>
</tr>
<tr>
<td>4. Refrigerator (Apt. 10) [Regulation 1.48-1(c)]</td>
<td>500</td>
</tr>
<tr>
<td>5. Refrigerator (Apt. 21) [Regulation 1.48-1(c)]</td>
<td>500</td>
</tr>
<tr>
<td>6. Refrigerator (Apt. 29) [Regulation 1.48-1(c)]</td>
<td>500</td>
</tr>
<tr>
<td><strong>C. Carpets:</strong></td>
<td></td>
</tr>
<tr>
<td>7. Carpeting (not glued down) (Apt. 10) [RR 67-349, PLR 7752075]</td>
<td>1,200</td>
</tr>
<tr>
<td>8. Carpeting (not glued down) (Apt. 21) [RR 67-349, PLR 7752075]</td>
<td>1,200</td>
</tr>
<tr>
<td>9. Carpeting (not glued down) (Apt. 29) [RR 67-349, PLR 7752075]</td>
<td>1,200</td>
</tr>
<tr>
<td><strong>D. Counters, Cabinets, Shelves:</strong></td>
<td></td>
</tr>
<tr>
<td>10. Counters, cabinets, shelves (Apt. 10) [Reg 1.48-1(c) Film N' Photos]</td>
<td>1,000</td>
</tr>
<tr>
<td>11. Counters, cabinets, shelves (Apt. 21) [Reg 1.48-1(c) Film N' Photos]</td>
<td>1,000</td>
</tr>
<tr>
<td>12. Counters, cabinets, shelves (Apt. 29) [Reg 1.48-1(c) Film N' Photos]</td>
<td>1,000</td>
</tr>
<tr>
<td><strong>E. Light Fixtures:</strong></td>
<td></td>
</tr>
<tr>
<td>13. Light fixtures (Apt. 10) [RR 72-398, Standard Oil]</td>
<td>165</td>
</tr>
<tr>
<td>14. Light fixtures (Apt. 21) [RR 72-398, Standard Oil]</td>
<td>165</td>
</tr>
<tr>
<td>15. Light fixtures (Apt. 29) [RR 72-398, Standard Oil]</td>
<td>170</td>
</tr>
<tr>
<td><strong>TOTAL PERSONAL PROPERTY:</strong></td>
<td>$10,000</td>
</tr>
</tbody>
</table>
Schedule of Real Property Capital Improvements (27-1/2 yrs., residential)

{Back Up Schedule Only. Do Not File With IRS}

<table>
<thead>
<tr>
<th>Description of Capital Improvement Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Plumbing – Bathroom fixtures related plumbing:</strong></td>
<td></td>
</tr>
<tr>
<td>[CITES: Herman Barron, TC Memo 1963-315; IRC 263(a)(1)]</td>
<td></td>
</tr>
<tr>
<td>1. Sink\vanity\medicine cabinet - Apt. 10</td>
<td>$500</td>
</tr>
<tr>
<td>2. Sink\vanity\medicine cabinet - Apt. 21</td>
<td>500</td>
</tr>
<tr>
<td>3. Sink\vanity\medicine cabinet - Apt. 29</td>
<td>500</td>
</tr>
<tr>
<td>4. Tub\shower kit - Apt. 10</td>
<td>800</td>
</tr>
<tr>
<td>5. Tub\shower kit - Apt. 21</td>
<td>800</td>
</tr>
<tr>
<td>6. Tub\shower kit - Apt. 29</td>
<td>800</td>
</tr>
<tr>
<td>7. Toilet - Apt. 10</td>
<td>408</td>
</tr>
<tr>
<td>8. Toilet - Apt. 21</td>
<td>408</td>
</tr>
<tr>
<td>9. Toilet - Apt. 29</td>
<td>408</td>
</tr>
<tr>
<td>10. Wall tile\flooring - bathroom, Apt. 10</td>
<td>900</td>
</tr>
<tr>
<td>11. Wall tile\flooring - bathroom, Apt. 21</td>
<td>900</td>
</tr>
<tr>
<td>12. Wall tile\flooring - bathroom, Apt. 29</td>
<td>900</td>
</tr>
<tr>
<td><strong>TOTAL 12 CAPITAL IMPROVS. (Form 4562, Line 15h)........................ $7,824</strong></td>
<td></td>
</tr>
</tbody>
</table>

Detailed Back-Up Schedule of Deductible Repairs & Maintenance

{Back Up Detailed Schedule Only. Do Not File With IRS}

<table>
<thead>
<tr>
<th>Description of Repair or Maintenance Item</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Outside:</strong></td>
<td></td>
</tr>
<tr>
<td>1. Driveway, patching [Knoxville Iron Co. TC Memo 1959-54]............</td>
<td>$</td>
</tr>
<tr>
<td>3. Painting, cleaning outside [ IRS Pubs 523, 527; PLR 1999490003]</td>
<td></td>
</tr>
<tr>
<td>4. Pointing\white washing [City National Bank, TC Memo, 4/23/52]</td>
<td></td>
</tr>
<tr>
<td><strong>Foundation\footings:</strong></td>
<td></td>
</tr>
<tr>
<td>5. Foundation piles [Illinois Merchants Trust Co. (1926) 4 BTA 103(A)]</td>
<td></td>
</tr>
<tr>
<td>7. Joists, extensive repairs [ Farmers Creamery Corp (1950) 14 TC 879]</td>
<td></td>
</tr>
<tr>
<td>8. Water damage, lining of basement [Midland Empire Packing, 14 TC635]</td>
<td></td>
</tr>
<tr>
<td><strong>Roofing:</strong></td>
<td></td>
</tr>
<tr>
<td>9A. New roof [Nevia Campbell, TC Summary Opinion 2002-117]..............</td>
<td></td>
</tr>
<tr>
<td>10. Reroofing with same materials [Thurner, TC Memo 1952, 11 TCM 42]</td>
<td></td>
</tr>
</tbody>
</table>
11. Replacing of roofing sheets  
[Knoxville Iron Co. TC Memo 1959-54]

12. Replace broken roof slate/stopping leaks  
[Knoxville Iron Co. Ibid.]

13. Replace deteriorated roof decking  

14. Repair leaking roof  
(Oberman Mfg Co. 47 TC 471; Pierce Estates, Inc. 16 TC 1020)

15. Gutter repairs  
[IRS Pubs 523, 527; Knoxville Iron Co. Ibid.]

D. Ceilings:

16. Extensive repairs to  
[Farmers Creamery Corp (1950) 14 TC 879]

17. Painting  
[RR 62-180; IRS Pubs 523,527; Chesapeake Corp of VA]

(1951) TC 668(A)

E. Walls:

18. Walls, extensive repairs to  
[Farmers Creamery Corp Ibid.]

19. Walls, new cement  
[Del. Steeplechase & Race Assn., TC Memo 10/17/50, 9TCM 893]

20. Plastering  
[IRS Pubs 523, 527; Sturgill Motor Co. TC Memo 1973-281]

21. Painting  
[RR 62-180; IRS Pubs 523,527; Chesapeake Corp of VA, Ibid]

22. Cleaning  
[PLR 1999490003]

23. Wallpaper  
[Rose v. Haverty Furniture Co., Ibid.; Markovits, 7/31/52, 11 TCM 823]

F. Flooring:

24. Carpet repairs  
[George S. Beck, TC Memo.1994-122]

25. Floor mending and resurfacing  
[G&R Corp, 8 TCM, 970]

26. Replace flooring -  
[Knoxville Iron Co. TC Memo 1959-54]

27. Reinforce sagging floors  
[Regenstein (1954) 121 F Supp 952]

28. Extensive repairs to floors  
[Farmers Creamery Corp Ibid.]

29. Pouring & finishing concrete floor  
[Hudlow, TC Memo 1971-218]

30. Other floor repairs  
[IRS Pubs 523, 527; Farmers Creamery Corp Ibid]

G. Steps:

31. Repairs/painting  
[Reg. 1.162-4; RR 62-180; IRS Pubs 527; Chesapeake Corp VA]

32. Concrete steps replacing wooden footing  
[Campbell, TC Memo, 1973-101]

H. Windows:

33. Replace broken windows  
[IRS Pub 527, Buckland, Ibid]

34. Replace broken glass  
[Rose v. Haverty Furniture Co., Ibid; Pub 523]

35. Replace old sills  
[Buckland (1946) 66 F Supp 681, 35 AFTR 161]

36. Other window repairs  
[Buckland, Ibid]

I. Plumbing/Heating:

37. Plumbing  
[Rose v. Haverty Furniture Co., 15 F2d 345]

38. Fixing leaks  
[IRS Pubs 523, 527]

39. Caulking  
[Reg. 1.162-4]

40. Heating repairs  
[Reg. 1.162-4]

J. Electrical:

41. Electrical repairs  
[Reg. 1.162-4]

K. Maintenance: (Including during a general plan of renovation)

([Reg. 1.162-4; Chesapeake Corp of VA., (1951) 17 TC 668(A)
43. Environmental clean-up; lead paint removal [RR 98-25; PLR 9411002] ............................................................... 1,635
43A Environmental clean-up; asbestos removal [Cinergy, Fed. Claims Ct] .................................................................
43B. Environmental clean-up; asbestos encapsulation costs [PLR 9411002] .................................................................
44. Cleaning supplies [See cites above under “Maintenance”] ............... 200
46. Equipment Rental [See cites above under “Maintenance”] ............... 200
47. Exterminating [See cites above under “Maintenance”] ....................... 500
48. Hardware [See cites above under “Maintenance”] ...........................
49. Janitorial [See cites above under “Maintenance”] ...........................
50. Lawn Care [See cites above under “Maintenance”] ...........................
51. “OdorXit” - getting rid of odors [See cites above under “Maintenance”]
52. Sanding [PLR 1999490003] .................................................................
53. Small tools (or use Section 179 first-year expensing via Form 4562) ...........
54. Snow Removal [See cites above under “Maintenance”] ....................
55. Supplies/materials, useful life of less than a year - Reg.1.162-3-...

L. Safety Supplies & Maintenance [Reg.1.162-3; Reg.1.162-4]:
57. Locks & Keys................................................................. 200
58. Fire Protection (extinguishers, exit signs, etc.) (or use Section 179)
59. Maintenance expenses to keep a property safe [John A. Schmid, 10 BTA 1152] .................................................................

M. Other:

TOTAL REPAIRS & MAINTENANCE ......................................................... $ 20,426

COPYRIGHT 2006 - ISU - ALL RIGHTS RESERVED (\RETXDK2\FMORM)

Reference Source (return tab): SAP 7

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized
copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE
LAW, regardless of intent: No matter if you make a profit or not, you are committing a
serious copyright infringement crime, punishable by severe fines and imprisonment, and
you may be held liable under BOTH civil and criminal law.
In this chapter we will cover the following

Reference Source (return tab): SAP 16

A. THE VALUE OF TAX CREDITS

B. REHABILITATION TAX CREDITS UNDER IRC 47

C. THE AMOUNT OF REHABILITATION TAX CREDITS

D. OVERVIEW OF REQUIREMENTS TO QUALIFY FOR CREDITS

E. THE 20% HISTORIC REHAB CREDIT – FURTHER DISCUSSION – CERTIFICATION

E-1. PROCESS & APPLICATION FOR CERTIFICATION OF A BUILDING AS A “CERTIFIED HISTORIC STRUCTURE”

E-2. THE EFFORT FOR THESE CREDITS COULD BE WELL WORTH IT

F. REHAB CREDITS AS THEY PERTAIN TO LESSEES

G. EFFECT OF PASSIVE LOSS LIMITS & AT-RISK RULES ON REHAB CREDITS

H. REHAB TAX CREDIT RECAPTURE

I. EFFECT OF AMT ON REHAB CREDITS

J. CARRYBACK OR CARRYFORWARD OF UNUSED REHAB CREDITS

K. TAX REPORTING FOR REHAB CREDITS

L. MORE INFORMATION FOR REHAB CREDITS FOR HISTORIC BUILDINGS
M. OTHER RELATED CREDITS OR REDUCTIONS

A. THE VALUE OF TAX CREDITS

1. Generally more value than deductions. Tax credits are generally more valuable than deductions. *Reason*: They reduce your tax liabilities dollar-for-dollar, whereas a deduction will partially reduce your taxes, depending on which tax bracket you are in.

2. Example: A $5,000 tax deduction in a 15% bracket reduces your taxes by $750 ($5,000 x 15%). On the other hand, a $5,000 tax *credit* reduces your taxes by $5,000 or a difference of **$4,250**. (For a further discussion of deductions-versus-credits, see Appendix A-2, APPA2)

B. REHABILITATION TAX CREDITS UNDER IRC 47

1. Credits for substantial improvements. Real estate property owners (and lessees) may be entitled to dollar-for-dollar tax credits for “substantial” improvements (or “rehab”) to rental or business-use properties. IRC 47(a). Technically called “rehabilitation credits”, they are sometimes called investment tax credits.

2. Not personal-use property. The credits are *not* available for personal-use property, such as a primary or second home. They are available only for rental/business-use properties.

C. THE AMOUNT OF REHABILITATION TAX CREDITS

The amount of the credit is based on two tiers as follows:

1. 20% credit for historic residential rental or commercial property. 20% of the amount of capital improvements for certified historic buildings, regardless of when the property was placed in service. The property can either be residential rental property (houses or apartment buildings); or non-residential (commercial/industrial) property.
2. **10% credit for commercial property only.** 10% of the amount of capital improvements for non-residential (commercial), non-historic (older) buildings. The non-residential (commercial)**, non-historic building must be first placed in service before 1936*, IRC 47(c)(1)(B).

(a) **Proof of age** - Obtain written proof that the non-historic property (10% credit) was built and placed in service in 1935 or before. The county clerk’s office or web site should have this.

(b) **Commercial, not residential rental** - Unfortunately, the 10% credit is not available for residential rental properties such as rental houses or apartment buildings. It is available for commercial and industrial property. More specifically - shopping centers, retail stores, office buildings, motels, hotels, storage facilities, garages, warehouses, plants, factories, etc. Regulation 1.48-1(h). [Note: When the 1986 tax act first came out this was not clear. Apparently (and unfortunately) it is now as per the above regulation]. Residential rental properties do qualify for the 20% historic credit.

(c) **The qualifying non-residential use is based on the present use of the property** - For the 10% credit of non-residential real estate, the determination of the type of property (residential or non-residential) is based on its use when it is placed in service after the rehab. For example, an apartment building renovated for use as an office building is treated as qualifying non-residential real estate, *Conference Committee Report, HR 13511*.

(d) **Mixed-use property (residential and non-residential)** - For mixed-use residential and non-residential property (such as stores on the first floor and apartments on the upper floors), it appears that the commercial units (such as the stores) will still qualify for the credit.

**D. OVERVIEW OF REQUIREMENTS TO QUALIFY FOR CREDITS**
For both non-certified historic and certified historic buildings, the improvements must be “qualified rehabilitation expenditures”, which mean the following:

1. **The expenditures must be depreciable real property capital improvements**, Reg. 1.48-12(c)(2). (Emphasis added)

2. **Straight line depreciation** must be used on the expenditures themselves, IRC 47(c)(2)(B)(i).

3. **The rehabilitation must be “substantial”**. This means that the improvements must exceed the greater of the adjusted basis of the building (not land) or $5,000 during a 24 month period selected by the taxpayer, IRC 47(c)(1)(C)(i); Reg. 1.48-12(b)(2).

For example, allocated building basis is $70,000, then rehab improvements must be at least $70,001 within the above 24 months or 60 months below.

   **Note**: Where there is a written set of architectural plans, the 24 month period may be extended to a 60 month period, IRC 47(c)(1)(C)(ii); Reg. 1.48-12(b)(2)(v).

4. **The basis of the building must be reduced by the full amount of the credit**. IRC 50(C) replacing former IRC 48(g).

5. **The rehab expenditures do not include the cost of acquiring the building itself** and do not include enlargements to the existing building, IRC 47(c)(2)(B)(ii)(iii).

Further requirements....

1. For the 10% credit of non-historic older commercial properties (only) the building must retain in place at least 75% of the external walls (including at least 50% as external walls) and at least 75% of the building’s internal structural framework, IRC 47(c)(1)(iii). **Note**: Historic buildings do not have to meet this test, but they do have to meet the next one.
2. For the 20% credit of historic residential rental or commercial properties (only), both the building and the improvements must be historically “certified”, IRC 47(a)(1); IRC 47(c)(3). Note: Non-historic properties do not have to meet this requirement. See Part E, next.

E. THE 20% HISTORIC REHAB CREDIT – FURTHER DISCUSSION – CERTIFICATION

Both commercial and residential (rental) properties could qualify for a 20% rehab credit to historic properties under special rules as per Internal Revenue Code Section 47. Included here are commercial and residential properties rented out, and commercial properties used in the owner’s business (such as your own offices). To qualify for the larger 20% rehab credit both the building and the improvements must be “certified”, IRC 47(a)(1); IRC 47(c)(3). The credit does not pertain to a personal residence.

All of the aforementioned requirements for the 10% credit (of the previous chapter) must be met, except the 50%/75% wall retention test which does not have to be met. This wall retention requirement pertains only to the 10% rehab credit for older commercial properties (see requirement 4 in the last chapter). Again, it does not pertain to the 20% rehab credit. Also, the requirement that the property be first placed in service before 1936 does not pertain to qualifying for the 20% credit. But such certified historic properties most likely will be older structures. But again, there is no particular yearly requirement as with the 10% rehab credit. Again, for properties to qualify as historic, both the building and the improvements must be “certified”, IRC 47(a)(1); IRC 47(c)(3). This is further explained.

(1) THE BUILDING: A certified historic structure includes any building (and its structural components) which is (a) Listed in the National Register of Historic Places, or (b) Is located in a registered historic district and is certified by the Secretary of the Interior as being of historic significance to such district, IRC 47(c)(3). A “registered historic district” is (i) any district listed in the National Register of Historic Places, and (ii) any district designated under a state or local statute, provided that such statute is certified by the Secretary of the Interior to the IRS as containing criteria that will substantially achieve the purpose of preserving and
rehabilitating buildings of historic significance to the district, and (iii) which is certified by the Secretary of the Interior to the IRS as meeting substantially all of the requirements for the listing of districts in the National Register, IRC 47(c)(3)(B).

(2) THE IMPROVEMENTS: “Certified rehabilitation” means any rehabilitation of a certified historic structure which the United States Secretary of the Interior certifies to the IRS as being consistent with the historic character of such property or the historic district in which such property is located, IRC 47(c)(2)(C). The National Park Service has two helpful publications, Secretary of the Interior’s Standards for Rehabilitation and Illustrated Guidelines for Rehabilitating Historic Buildings (both available free at www.cr.nps.gov/hps.

E-1. PROCESS & APPLICATION FOR CERTIFICATION OF A BUILDING AS A “CERTIFIED HISTORIC STRUCTURE”

Your building must be listed-or be eligible for listing-on the National Register of Historic Places or a state historic register. Listing is not dependent on the age of the building. It depends only on its historical significance. Designation as historic also dictates, to some extent, the types of changes you can and cannot make to the structure. Be certain that the building qualifies as historic before you proceed with any improvements so that you’ll be able to claim the credit. To learn whether a structure has national designation (thousands already do), go to the National Park Service Web site at www.cr.nps.gov/nr. To learn whether a structure has state designation, contact your state’s agency for historic preservation, commerce, or community development.

To get a building listed and if you believe that a property is of historic significance, apply for designation before you start renovating as per the following. Part I of the Historic Preservation Certification Application (NPS Form 10-168a) must be completed by owners of properties within registered historic districts who seek certification of the structure as being of historic significance to the district. The completed application is first reviewed by the appropriate state authority which is the state historic preservation office or SHPO. The application is then forwarded to the National Park Service in the Department of the Interior for certification. A historic listing does not require you to open your property to the public or receive permission from the federal or state government to make renovations. A listing, or application for a listing, is necessary for claiming a tax credit. To claim the federal tax credit, you
must pay a fee to the National Park Service of $250 to $2,500, depending on the projected amount of qualifying expenditures. This fee covers submission of your application that includes your plan for renovation, something that needs National Park Service approval.

**APPLICATION STRATEGIES:** (1) Use an architect, who not only is expertised in certified rehabilitation in your area, but also familiar (preferably intimately familiar) with the particular SHPO. Using an architect’s plans will also increase the 24 months period to a 60 month period regarding the important requirement of “substantial rehabilitation”. (See requirement 7 from the last chapter). (2) Check your local building and fire code laws. *Reason:* When you renovate, an old building must be brought up to local building code requirements. (3) Get to know and work with local building inspectors, who may help you devise creative solutions to the building code challenges of older structures. You might be able to obtain a variance from a code requirement, such as for a narrow staircase, provided your solution does not present a danger to the public. (4) If the building has public access (a commercial building, for example), you must also comply with the Americans With Disabilities Act, a federal law setting standards for handicapped accessibility. State law may also impose public access rules for the handicapped* (e.g., Vermont’s law is stricter than the federal law). However, federal and state laws may provide alternatives for compliance—for example, a steeper ramp or a secondary entry. (5) Mail the application certified mail with a return receipt. (*See Goldmine Chapter 18, Strategy 14 for handicapped improvements and access credits).

**E-2. THE EFFORT FOR THESE CREDITS COULD BE WELL WORTH IT**

Again, while the above may seem like a lot to do, remember the value of these dollar-for-dollar credits that go right in your pocket. Moreover, historic properties (especially apartment or office buildings) could command higher rents and consequently increase property value. This is partly because of the “new markets credit” created by the federal Community Renewal Tax Relief Act of 2000, intended to encourage development in low-income communities. This credit, when combined with federal and state credits for rehabilitating historic structures, plus the potential for capital appreciation, could make investments in historic properties highly attractive.
SCENARIO: Years ago I remember a lady who owned an apartment building in a desirable area. It was a stately looking property with definite historic character. However, it had a tacky name (like the “Sanford Arms”) and needed a lot of rehab to restore the property to its original historic character. So she did the necessary qualifying improvements of $100,000 at that time to upgrade the property and qualify for the 20% rehab credit. She also changed the name to “Apartments Of Distinction”. Result: She more than doubled her rents, dramatically increased the property’s value and ended up with $20,000 of tax credits in her pocket. She made more money from the property and from the IRS!

F. REHAB CREDITS AS THEY PERTAIN TO LESSEES

The rehab credits are available for lessees of qualifying property provided that on the rehabilitation’s completion date, the remaining term of the lease (without regard to any renewal period) is as long as the applicable recovery period for the building, IRC 47(c)(2)(B)(vi). The lessor may elect to pass the rehab credit to the lessee for qualifying rehabilitation performed by the lessor, Reg. 1.48-12(f)(1).

G. EFFECT OF PASSIVE LOSS LIMITS & AT-RISK RULES ON REHAB CREDITS

1. Rehab credits are subject to the passive loss limitation. For purposes of this limitation the credit would be computed on a loss equivalency basis. [See Appendix B, Part 8].

2. More liberal AGI requirement for $25,000 loss exception. One important difference is that for purposes of coming under the $25,000 active loss exception, the maximum adjusted gross income is increased from $150,000 to $250,000 for the $25,000 loss exception (in deduction-equivalent credits), IRC 469(i)(3)(B). Any unused amounts are carried forward indefinitely until used up.

[Note: For low-income housing credits there is no maximum AGI, IRC 469(i)(3)(C). Therefore, for the purposes of claiming low income housing

8
credits, the investor can make any amount of income. For a further discussion of low-income housing tax credits, see the next chapter.

3. For the rehab credits (and low-income housing tax credits), there is no active participation requirement, IRC 469(i)(6)(B). Therefore, such credits in a limited partnership (LP) can qualify for the $25,000 loss allowance (in deduction-equivalent credits, per Appendix B (PAPPB), Part 8).

Note: This is even so, despite that LP’s are subject to passive loss limits for the purposes of claiming rental property losses.

4. Strategy: Fully claim all rehab credits without limits by completely avoiding passive loss limitations as an active real estate professional (see Chapter 26.)

5. Rehab tax credits may be subject to the Section 465 at-risk rules. IRC 49(a)(1). For a further discussion of the at-risk rules, including planning strategies, see Chapter 27.

H. REHAB TAX CREDIT RECAPTURE

1. All or part of the credit allowed to a taxpayer may be recaptured as additional tax if the taxpayer prematurely disposes of the property or employs it into a disqualifying use. Recapture occurs only if the actual period during which the taxpayer holds the property (or employs it in a qualifying use) is shorter than that used by the taxpayer in claiming the credit. Generally, 20% of the credit taken is recaptured for each full year of an early disposition. There is no recapture for eligible property actually held or used in a qualifying activity for at least 5 years. IRC 50(a)(1)(B). The schedule of recapture of recovery property is as follows:

<table>
<thead>
<tr>
<th>Holding Period</th>
<th>% of Recapture of credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than:</td>
<td></td>
</tr>
<tr>
<td>1 year..........</td>
<td>100%</td>
</tr>
<tr>
<td>2 years........</td>
<td>80%</td>
</tr>
<tr>
<td>3 years........</td>
<td>60%</td>
</tr>
<tr>
<td>4 years........</td>
<td>40%</td>
</tr>
<tr>
<td>5 years........</td>
<td>20%</td>
</tr>
<tr>
<td>after:</td>
<td>none</td>
</tr>
</tbody>
</table>


2. The holding period has nothing to do with the taxpayer’s tax year. But instead pertains to the particular asset’s holding period which begins when the asset is “placed in service” and ends when the asset is disposed of or is otherwise subject to an event that triggers recapture.

3. Recapture applies only to credits that have actually reduced a tax liability. Thus, if a credit is never used, it is not recaptured.

I. EFFECT OF AMT ON REHAB CREDITS

While rehab credits can reduce federal income taxes, they cannot be used to offset alternative minimum tax (AMT), but see update below. (AMT is computed on IRS Form 6251 and is discussed in Appendix F). But unused rehab credits can be carried back or forward as per Part J (next).

UPDATE – GOOD NEWS: Rehab credits (and low income housing credits) can now can offset the AMT. This rule applies to rehabilitation expenses incurred after 2007 (and also low income properties are put in service after 2007).

J. CARRYBACK OR CARRYFORWARD OF UNUSED REHAB CREDITS

If you cannot use part or all of the credit because of the income tax liability limit, carry the excess back 1-year and then forward 20 years. See the separate instructions for Form 3800 for details.

K. TAX REPORTING FOR REHAB CREDITS

1. IRS forms 3468 and 3800. Rehab tax credits are reported on IRS Form 3468 (Investment Credit), Part 1, for the tax year that the credit is claimed. You also must complete IRS Form 3800.
2. The following information should be shown on the form. (a) the beginning and ending dates of your selected 24-month or 60-month measuring period; (b) the building’s adjusted basis as of the beginning of the measuring period; (c) the amount of qualifying rehab credits during the measuring period, Reg. 1.48-12(b)(2)(viii). If you are claiming a credit for a certified historic structure, you must attach a copy of the final certification of competed work by the Secretary of the Interior and evidence that the building is a certified historic structure. If the final certification has not been received by the filing date of your return, then attach a copy of the first page of the Historic Preservation Certification Application (NPS Form 10-168a), with proof that it was received by the Department of the Interior or the State Historic Preservation Officer along with evidence that the building is a certified historic structure (or that such status has been requested).

3. For further filing requirements, see the instructions that go along with Form 3468.

L. MORE INFORMATION FOR REHAB CREDITS FOR HISTORIC BUILDINGS


2. National Trust for Historic Preservation. A tax exempt organization formed by Congress to encourage public participation in preserving districts, buildings, etc. which are significant in American history and culture. The Trust is located at: 1785 Massachusetts Avenue, NW Washington, D.C. 20036.

Park Service has two helpful publications, *Secretary of the Interior’s Standards for Rehabilitation* and *Illustrated Guidelines for Rehabilitating Historic Buildings* (both available free at www.cr.nps.gov/hps.)

4. **Books.** All kinds of books can be bought on the topic at the Government Printing Office bookstores.

5. ** Guidelines.** Copies of the standards and guidelines for applying to the Secretary of the Interior’s “Standards for Rehabilitation”, literature (preservation briefs) on rehabilitation techniques for historic buildings on topic such as cleaning, coating, and repair of masonry, store front alteration, window treatments and the use of artificial exterior siding and a fact sheet entitled “Review of Rehabilitation Work” are available by writing to: Historic Preservation Tax Incentives, Archeology and Historic Preservation, National Park Service, Washington, D.C. 20240.

**M. OTHER RELATED CREDITS OR REDUCTIONS**

1. **State Tax Credits.** Your state may also provide tax credits designed to encourage rehabilitation of historic structures; almost half the states do. Maine and North Carolina, for example, offer a 20% credit to an owner who qualifies for the federal 20% credit, for a total credit of 40% of renovation costs. Missouri and Virginia have a 25% credit, for a total credit of 45%. New Mexico has a credit of up to 50% of costs up to
$25,000. Iowa’s credit, 25%, is restricted to historic barn renovation. Check with your own state.

2. **New Markets Credit.** This credit, designed to encourage investments in community development entities (CDE’s). These are entities that provide investment capital for low-income communities. The credit is spread over seven years. It is 5% of the stock or capital interest in a CDE for each of the first three years and 6% annually for the final four years. The credit is figured on Form 8874, New Markets Credit. It is subject to the same limitations as the rehabilitation credit described above.

   **TAX BREAK:** Both the rehabilitation credit and the new markets credit may be claimed for the same investment.

3. **The Disabled Access Credit (IRC 44)** – This credit results from expenditures to modify a building to accommodate handicapped and elderly persons (*Removal of Architectural Barriers*). The credit cannot exceed 50% of expenditures over $250, but not more than $10,250. The maximum credit is $5,000. You claim the credit on IRS Form 8826. For a further discussion, see Goldmine Chapter 21-A.

4. **Property Taxes.** Numerous states offer real property tax reductions (typically called abatements) for historic properties. Consult your local tax assessor for details.

Reference Source (return tab): **SAP 16**

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may sold (including on the internet), be transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime,
punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
More Dollar-For-Dollar Tax Credits
For Low-Income Housing

In this chapter we will discuss...

A. WHAT ARE LOW-INCOME HOUSING CREDITS?
B. THE LIC PERCENTAGES FOR LOW-INCOME BUILDINGS
C. LIC EXAMPLES
D. QUALIFIED LOW-INCOME HOUSING
E. HOW TO OBTAIN THE CREDITS
F. EFFECT OF PASSIVE LOSS LIMITS ON LIC'S
G. RECAPTURE OF THE CREDIT
H. EFFECT OF AMT ON LIC'S
I. CARRYBACK OR CARYFORWARD OF LIC’S
J. TAX REPORTING FOR LIC’S
K. FURTHER INFORMATION ABOUT LIC’S

A. WHAT ARE LOW-INCOME HOUSING CREDITS?
1. Low-income credits (LIC’s) are dollar-for-dollar tax credits for residential rental property that qualifies as low-income housing under the tax law.

2. Over a 10 year period. The credit is claimed every year over a 10-year period, using IRS Form 8586. Thus, you receive the credit every year for 10 years. The credit is taken on the building only, not the land.

3. Tax credits not rent subsidy program. “Low income” here does not mean a rent-subsidy program such as a Section 8 or HUD program. LIC’s come under a tax provision as per IRC 42. However, because both programs focus on lower-income scenarios, a property may coincidentally qualify for both the Section 8 rent-subsidy program and the low-income housing tax credits.

**B. THE LIC PERCENTAGES FOR LOW-INCOME BUILDINGS**

The LIC percentages for low-income buildings placed in service after 1986 are:

1. **Total credit of 70%** (spread out over 10 years) of the qualified basis of new* buildings which are *not* federally subsidized (**or 7% a year** for the next 10 years), IRC 42(b)(1)(B). Included in this category are also rehab improvements. The rehab must be depreciable real property capital improvements and exceed $3,000 per property, IRC 42(e)(3). Therefore, you can receive this credit on the qualifying cost of the new* building itself and for qualifying improvements to that building.

   [**”New”** means newly built or newly renovated where the property was never used for residential purposes, such as where an office building is converted into apartments]

2. **Total credit of 30%** (spread out over 10 years) of the qualified basis of certain federally subsidized** new buildings or non-federally subsidized
existing buildings (or **3% a year** for the next 10 years), IRC 42(b)(1)(B)*. [*For older existing properties, the building must have been purchased and must have been in service for at least 10 years, IRC 42(d)(2)(B)].

[**A new building** is federally subsidized for any tax year if, any time during the year, or earlier tax year, there was outstanding any tax exempt obligation under IRC 103, or if there is outstanding any below-market federal loans, the proceeds of which were used directly or indirectly for the building or its operation, IRC 42(i)(2)(A). Under certain conditions a building may not be considered to be federally subsidized for construction financing. See IRC 42(i)(2)(C)].

**C. LIC EXAMPLES**

**7% Per year credit:** You buy a new qualifying apartment building for $200,000. You are therefore entitled to a 70% or $140,000 tax credit spread out over 10 years, or 7% a year for the next 10 years. This means that for each of the next 10 years you are entitled to a $14,000 dollar-for-dollar LIC (7% x $200,000).

**3% Per year credit:** Same facts, except you buy a 10 year old (or more) apartment building for $300,000. You are therefore entitled to a 30% or $90,000 tax credit spread out over 10 years, or $9,000* a year LIC (*3% x $300,000). Same facts, except you buy a 10 year old (or more) rental house for $50,000. You are therefore entitled to a 30% or $15,000 tax credit spread out over 10 years, or $1,500* a year dollar-for-dollar LIC (*3% x $50,000).

**D. QUALIFIED RESIDENTIAL LOW-INCOME HOUSING**

The LIC’s can only be claimed for residential rental buildings that meet one of the following minimum set-aside tests, per IRC 42(g)(1):
(1) **20-50 test** - 20% or more of the residential units in your property are both rent-restricted and occupied by individuals whose income is 50% or less than the area median gross income, or

(2) **40-60 test** - 40% or more of the residential units in your property are both rent-restricted and occupied by individuals whose income is 60% or less than the area median gross income (in New York City it’s a 25-60 test). See the instructions for Part II, line 10c of IRS Form 8609 for current details.

(3) **Irrevocable election of either test.** You may elect either test for the project, but once made, the election is irrevocable. The test elected must be the same for all buildings in the project. Use Form 8609 to make this election. See IRC 42 (g) for more details.

**E. HOW TO OBTAIN THE CREDITS**

1. **By each state.** The credits are allocated from the IRS to each of the 50 states via a contract with each state (which supposedly varies from state to state). You therefore have to go through your state agency which is in charge of distributing, managing and handling LIC’s.

2. **Limited amount of LIC’s.** Only so much LIC’s are allocated, so once they are used up, that’s it for the year.

3. **State agency.** You can find your state agency by calling HUD, your local IRS office or your state capital. You can also check the government pages of the telephone directory, under “housing” or “bureau of housing”. Also check the internet. Once you find out the contact office, start moving fast and expect some bureaucratic red tape and perhaps some difficulty, but could be well worth it.

4. **What you must obtain from the state or local housing credit agency is IRS Form 8609** *(Low-Income Housing Credit Allocation Certification)*, with
Part I completed (by the state) for each building for which you are claiming a credit.

**F. EFFECT OF PASSIVE LOSS LIMITS ON LIC’S**

1. **Low-income housing credits are subject to the passive loss limitations.** See the separate instructions for Form 8582-CR, *Passive Activity Credit Limitations*. For purposes of this limitation the credit would be computed on a loss-equivalency-basis. [See Appendix B (PAPPB), Part 8].

2. **Tax Break: No AGI requirement for $25,000 loss exception.** One important difference is that for purposes of coming under the $25,000 active loss exception, there is no maximum adjusted gross income limit, IRC 469(i)(3)(C). Therefore, for the purposes of claiming low income housing credits, the investor can make any amount of income, although they may be limited by the $25,000 loss limit.

3. **Tax Break: For the LIC’Ss (and rehab credits)s, there is no active participation requirement**, IRC 469(i)(6)(B). Therefore, such credits in a limited partnership can qualify for the $25,000 loss allowance (in deduction-equivalent credits, discussed in Appendix B). This provision makes real estate, qualifying for LIC’s, an attractive investment for limited partnership syndications, and even better LLC syndications.

4. **Strategy: Fully claim all LIC credits without limits by completely avoiding passive loss limitations as an active real estate professional** (see Chapter 26.)

**G. RECAPTURE OF THE CREDIT**
There is a 15-year compliance period during which the residential rental building must continue to meet certain requirements. If, as of the close of any tax year in this period, there is a reduction in the qualified basis of any building from the previous year, you may have to recapture a part of the credit you have taken. Similarly, you may have to recapture part of the credits taken in previous years upon certain dispositions of the building or interests therein. Use IRS Form 8611, *Recapture of Low-Income Housing Credit*. For more information, see the instructions for Form 8611 and IRC 42(j).

**H. EFFECT OF AMT ON LIC’S**

While LIC’s can reduce federal income taxes, they cannot be used to offset alternative minimum tax (AMT), **but see update below**. (AMT is computed on IRS Form 6251 and is discussed in Appendix F). However, unused LIC’s can be carried back or forward as per Part I (next).

**UPDATE – GOOD NEWS:** Low income housing credits (and rehab credits) can now can offset the AMT. This rule applies to low income properties are put in service after 2007 (and also rehabilitation expenses incurred after 2007).

**I. CARRYBACK OR CARYFORWARD OF LIC’S**

If you cannot use part or all of the credit because of the income tax liability limit, carry the excess back 1-year and then forward 20 years. See the separate instructions for Form 3800 for details.

**J. TAX REPORTING FOR LIC’S**

1. **IRS forms 8586, 8609, 8609-A, 8611.** You use IRS Form 8586 to claim the low-income housing credit. Attach to your return a copy of the completed Form 8609 and accompanying Schedule 8609-A (from your state agency) for each building for each year of the 15-year compliance period. You must also certify
certain first-year information to the IRS on Form 8609. If this certification is not made, you may not claim a credit for that building. Keep a copy of Form 8586 together with all Forms 8609, Schedule(s) A of Form 8609, and Form 8611 for 3 years after the 15-year compliance period ends. See the instructions for Form 8586.

2. **Beginning of 10-year period.** In general, the 10-year credit period starts at the beginning of the tax year in which the building is placed in service. However, you may elect to begin the 10-year credit period in the tax year after the year the building was placed in service by checking the “Yes” box in Part II, line 10a of Form 8609, *Low-Income Housing Credit Allocation Certification*.

3. **For entities.** S Corporations, Partnerships, Estates, and Trusts: These entities complete Part I to figure the credit to pass through to the shareholders, partners, or beneficiaries. Attach Form 8586 to the entity’s income tax return along with Form 8609, and Schedule A (Form 8609), Annual Statement, for each building. Presumably the same for LLC-partnerships.

**K. FURTHER INFORMATION ABOUT LIC’S**

1. **Publications.** The above is an overview of a very complex topic. For further information refer to IRC 42 and the instructions for the above forms. There is one book that I know of, *Low-Income Housing Tax Credit Handbook* by Michael J. Novogradac, CPA; Jan E. Krabbenschmidt, Esquire; and Robert S. Thesman, CPA. Published by West Group, 1-800-344-5009.

2. **LIC expert.** An expert on LIC’s is James Lipshultz. For many years Mr. Lipshultz has owned low-income housing. In fact it’s his full-time business. He has extensive experience with the application of LIC’s. Mr. Lipshultz is available for paid consultations only, either by phone, fax, mail, email or in person. He can be reached at (610) 352-0333.
3. Also check the internet.

Reference Source (return tab): SAP 17
Claim A Credit For Expenditures For The Handicapped (*Disabled Access Credit*, IRC 44).

Reference Source (return tab): **SAP 18**

If you will be doing renovations to a property instead of a deduction, you can alternatively claim a credit (up to certain limits) for the handicapped.

**1. Type Expenses:** These are expenses to modify a building to accommodate handicapped and elderly persons. They involve the installation of ramps, widening of doorways and lavatories to allow for wheelchairs and other such improvements to accommodate the handicapped or elderly as per the *Americans With Disabilities Act* (ADA).

**2. Credit instead of deduction:** Under IRC 44, eligible small businesses (including rental property owners) can alternatively claim a dollar-for-dollar tax credit for these types of expenses. If you claim the credit, you cannot also claim a deduction for the same expenditures as discussed in Chapter 18-A.

**3. Credit Amount:** The credit cannot exceed 50% of expenditures over $250, but not more than $10,250. The maximum credit is $5,000.

**4. Goldmine Form to Use:** See the next page (same one as for the alternative deduction in Chapter 18-A).

**5. IRS Form to Use:** You claim the credit on IRS Form 8826.

**6. More info:** IRS Pub 535 and IRS Form 8826.
**FORM: Schedule of Expenditures for The Handicapped –**

{Guidance on acceptable standards for the elderly and handicapped}

Year:__________

Property:_____________________________________________________________

<table>
<thead>
<tr>
<th>Type Expense</th>
<th>Requirements</th>
<th>Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>1) Grading</td>
<td>The ground should be graded to attain a level with a normal entrance to make the facility accessible to individuals with physical disabilities.</td>
<td>$_______</td>
</tr>
<tr>
<td>2) Walks</td>
<td>A public walk should be at least 48” wide and have a gradient of no more than 5%. A walk should have a continuing common surface (not interrupted by steps or abrupt changes in level). A walk or driveway should have a nonslip surface.</td>
<td>$_______</td>
</tr>
<tr>
<td>3) Parking lots</td>
<td>At least one space that is accessible and approximate to the facility must be set aside and designated for the handicapped. The space must be open to one side to allow wheelchair access. For head-on parking, the space must be at least 12 ft. wide.</td>
<td>$_______</td>
</tr>
<tr>
<td>4) Ramps</td>
<td>A ramp should not have a slope greater than a 1” rise in 12”. There must be a handrail 32” in height. A ramp should have a nonslip surface. A ramp should have a level surface at the top and bottom (if a door swings into the platform, the platform should be at least 5’ X 5’). A ramp should have level platforms at least every 30’. A curb ramp should be provided at every intersection (the ramp should be 4’ wide with transition between two surfaces and a non-slip surface)</td>
<td>$_______</td>
</tr>
<tr>
<td>5) Entrances</td>
<td>A building should have at least one primary entrance wheelchair accessible and on a level accessible to an elevator.</td>
<td>$_______</td>
</tr>
<tr>
<td>6) Doors and doorways</td>
<td>A door should have an opening of at least 32”. The floor inside and outside of the doorway should be level for at least 5’ from the door in the direction the door swings and must extend at least 1’ past the opening side of the door way. The threshold should be level with the floor. The door closer should not impair the use of the door by someone who is handicapped.</td>
<td>$_______</td>
</tr>
<tr>
<td>7) Stairs</td>
<td>Stairs should have handrails at least 32” from the tread at the face of the riser. Steps should not have risers exceeding 7”.</td>
<td>$_______</td>
</tr>
<tr>
<td>8) Floors</td>
<td>Floors should have a nonslip surface.</td>
<td>$_______</td>
</tr>
<tr>
<td></td>
<td>Description</td>
<td>Cost</td>
</tr>
<tr>
<td>---</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>9</td>
<td>Toilet rooms The room should provide wheelchair access. At least one stall should be 66” wide by 60” deep, with 32” door space and handrails.</td>
<td>$_______</td>
</tr>
<tr>
<td>10</td>
<td>Water fountains A water fountain or cooler should have upfront spouts and hand and foot controls. A water fountain should not be in an alcove unless there is 36” of space.</td>
<td>$_______</td>
</tr>
<tr>
<td>11</td>
<td>Public telephones The phone should be placed so the dial and headset can be reached by someone in a wheelchair. Coin slots should be not more than 48” from the floor. Public phones should be equipped for those with hearing impairments.</td>
<td>$_______</td>
</tr>
<tr>
<td>12</td>
<td>Elevators An elevator should be on entry levels to buildings and all areas normally used. Cab size should allow a wheelchair to turn. The door opening should be at least 32”.</td>
<td>$_______</td>
</tr>
<tr>
<td>13</td>
<td>Controls Switches and controls for all essential uses (light, heat, ventilation, window, draperies, fire alarms) should be within reach of a person in a wheelchair (no higher than 48” from the floor).</td>
<td>$_______</td>
</tr>
<tr>
<td>14</td>
<td>Identification Raised letters or numbers should be used to identify rooms (letters or numbers placed on the left or right of the door at a height of 54” to 66”).</td>
<td>$_______</td>
</tr>
<tr>
<td>15</td>
<td>Warning Signals A visual warning signal should be accompanied by an audible sound for the benefit of the blind.</td>
<td>$_______</td>
</tr>
</tbody>
</table>

**TOTAL** .................................................................................................................. $_______

Reference Source (return tab): **SAP 18**

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in
whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
How Not To Lose Interest Deductions On Your Properties – You Will - Unless You Plan

Reference Source (return tab): SAP 8

In this chapter will cover...

A. TYPES OF DEDUCTIBLE, PARTIALLY OR NON-DEDUCTIBLE INTEREST

B. A LIST OF THESE INTEREST CATEGORIES AND HOW THE INTEREST IS DEDUCTED

C. HOW THE LOAN FUNDS ARE USED DETERMINES HOW DEDUCTED – TRACING RULES

C-1. EXAMPLES OF THE ABOVE TRACING RULES

D. DO NOT COMMINGLE FUNDS

E. EXCEPTION TO TRACING RULES - INTEREST ON SECURED HOME EQUITY LOANS UP TO $100,000 IS FULLY DEDUCTIBLE - NO MATTER HOW THE FUNDS ARE USED

F. PLANNING STRATEGIES ON HOW TO CLAIM INTEREST DEDUCTIONS IF YOU REFINANCE YOUR RENTAL PROPERTY

G. SAMPLE STATEMENT TO RECLASSIFY RESIDENCE INTEREST AS BUSINESS INTEREST (Blank and Sample Filled-In)

A. TYPES OF DEDUCTIBLE, PARTIALLY OR NON-DEDUCTIBLE INTEREST

1. Prior law - easier. Before 1987, deducting interest was not only more liberal, but was also much simpler. Save for a couple of exceptions, any type of interest was tax deductible with generally no limit on the amount of the deduction.
2. **Today – more complex, calls for more planning.** Presently deducting interest is neither automatic nor simple. Under complex rules [IRC 163(h)] the tax treatment of interest can range from fully deductible to partially deductible to not deductible at all, depending on the category of interest.

**B. A LIST OF THESE INTEREST CATEGORIES AND HOW THE INTEREST IS DEDUCTED**

How the interest is deducted and the IRS form where it is deducted is below:

<table>
<thead>
<tr>
<th>Category</th>
<th>Type of Interest</th>
<th>Where Deducted</th>
</tr>
</thead>
<tbody>
<tr>
<td>Category 1:</td>
<td>Qualified Residence Interest</td>
<td>Itemized deduction - Schedule A</td>
</tr>
<tr>
<td>Category 2:</td>
<td>Business Interest (Full business deduction)</td>
<td>Business schedule, such as Schedule C (not recommended) or even better a corporation, 1120 or 1120S or if business run as a partnership, 1065</td>
</tr>
<tr>
<td>Category 3:</td>
<td>Rental Property Interest (Passive activity interest)</td>
<td>Schedule E (not recommended) or the preferred partnership form 1065, could be subject to passive loss limits without planning.</td>
</tr>
<tr>
<td>Category 4:</td>
<td>Investment interest - Such as a margin account for stocks</td>
<td>Itemized deduction with possible limits - Schedule A\form 4952.</td>
</tr>
<tr>
<td>Category 5:</td>
<td>Consumer (Personal) Interest</td>
<td>Not deductible at all.</td>
</tr>
</tbody>
</table>

**C. HOW THE LOAN FUNDS ARE USED DETERMINES HOW DEDUCTED – TRACING RULES**
Except for category 1 (Residence Interest), the deductibility of interest will depend on how the loan monies are used (not the type of collateral-security used for the loan). Accordingly for categories 2 through 5, the deductibility (or non-deductibility) of interest depends on what you spend the money for. These rules are called “tracing” rules.

C-1. EXAMPLES OF THE ABOVE TRACING RULES

(1) Ms. investor refinances her rental property and takes out $30,000 in cash which she uses to open up her own real estate brokerage company to be operated as a single proprietorship. The related interest on the refi loan is treated as category 2 - Business Interest - and is fully deductible as a business expense on her schedule C. If the real estate brokerage company is operated as an S-corp, then the interest is fully deductible on form 1120S.

It will not be deducted on a rental schedule, even though the security for the loan is a rental property. Had the loan funds been used for personal purposes, the interest is treated as category 5 - Consumer (Personal) Interest -is not deductible at all. Again, it makes no difference that the rental property is the security for the loan.

(2) Mr. I refinances his rental property and takes out $25,000 in cash to invest in stocks. The related interest on the refi loan is treated as category 4 - “Investment Interest” and is deductible up to the amount of investment income such as interest & dividends (unused deductions can be carried over). Again, it will not be deducted on the schedule for rental properties, even though the security for the loan is a rental property. If Mr. I used a margin account to buy the securities, the interest would again be investment interest (which is deducted on Schedule A).

D. DO NOT COMMINGLE FUNDS

1. Do not commingle borrowed funds with unborrowed funds. If you commingle the borrowed funds with your other unborrowed funds, then you can lose interest deductions on the loan.
2. **Separate accounts.** You need to keep *separate accounts* for your business, rental properties, investments, and personal.

3. **Try not to use the borrowed monies for personal expenditures.** If you want to borrow to buy a personal-use item, make the purchase first from your savings account; then restore the savings account with the borrowed money. In this scenario, your savings account is an “investment” and therefore the loan interest is at least deductible as “investment interest” (which is better than being non-deductible personal interest).

**E. EXCEPTION TO TRACING RULES - INTEREST ON SECURED HOME EQUITY LOANS UP TO $100,000 IS FULLY DEDUCTIBLE - NO MATTER HOW THE FUNDS ARE USED**

1. **Category 1 (Qualified Residence Interest)** includes home equity loans on a principal or second residence, IRC 163(h)(5).

2. **For home equity loans* up to $100,000, it makes no difference how the funds are used**, IRC 163(h)(3)(C). The related interest is fully deductible as residence interest which is an itemized deduction on Schedule A of your 1040. (Loan funds beyond the $100,000 would come under the previously discussed tracing rules, part C and C-1).

3. **Secured by your primary or second residence.** For the home equity loan to be deductible as “qualified residence interest” the loan must be specifically *secured* by your primary or second residence, Reg.1.163-10T (j)(1); Reg. 1.163-10T (o)(1). Such security is accomplished by a mortgage, deed of trust or a land contract. This means that these instruments must be recorded, including a land contract. Do this with competent legal counsel.

4. **Example 3 – Fully deductible:** You take out a home equity loan for $100,000 on your residence. The loan is secured by a mortgage on your home. The money is used for the following purchases:

   Home improvements............$ 20,000
Rental property: 50,000  
Business equipment: 10,000  
Fund your qualified Plan: 10,000  
Personal and recreational: 10,000  
Total: $100,000

The tax treatment of the related qualified interest expense is fully deductible as residence interest on Schedule A, regardless of how these loan proceeds are used. (Note: Even the personal\recreation portion is deductible under this exception).

5. **Above $100,000.** For home equity loans above $100,000 the related interest is subject to the tracing rules in that the deductibility (or non-deductibility) of interest depends on what you spend the money for. Therefore put the borrowed funds in a separate business account and use for business purposes.

6. **Qualified Residence Interest** also includes the allowance of a Schedule A interest deduction on debt up to $1,100,000 on a principal or second residence, IRC 163(h)(3) (A)(i). **Qualified Residence Interest** also includes the allowance of a Schedule A interest deduction on debt up to $1,000,000 on a principal or second residence. If you add $100,000 for home equity interest it is $1,100,000. For a primary or second homeowner, interest paid beyond the $1,100,000 is not deductible. As confirmed by 2009 Memo of IRS National Office. For a primary or second homeowner, interest paid beyond the $1,100,000 is not deductible, IRC 163(h)(3)(B)(ii)].

F. PLANNING STRATEGIES ON HOW TO CLAIM INTEREST DEDUCTIONS IF YOU REFINANCE YOUR RENTAL PROPERTY

1. **Do not commingle funds.** Where cash from the loan will be used for different purposes (such as business and investment), then you should keep the funds in separate accounts so the particular type of interest can be clearly identified.

For instance, you know you will be buying $25,000 of business equipment. Put the loan funds into your business account and send the check to the vendor. The same holds true for the purchase of
stocks - open up a separate “investment account”. For rental real estate put the funds in your separate “rental account” (or even better an LLC business account) and then purchase the real estate. Use separate non-personal accounts for each purpose.

2. Deposit in taxable savings account. If you are uncertain where the refi funds will go, then immediately deposit them into a new separate (taxable) interest-bearing savings account.

Your savings account is an “investment” and therefore the interest is deductible as “investment interest”.

3. Do NOT use the borrowed funds from the refinance of an investment property to purchase or improve a primary or second home.

This is a costly tax trap because if you do this, the interest will not be deductible at all. Reason: You are using the monies for personal purposes [IRC 163(h)] and you cannot come under the residence interest exception (5 below) as the loan is not secured by your primary or second home. It is secured by the rental property, Reg.1.163-10T (j)(1); Reg. 1.163-10T (o)(1). TAM 9418001.

4. Do NOT put the borrowed funds in your personal bank account.

5. With the borrowed funds do NOT make direct purchases of personal-use items (such as a fur coat).

6. Do NOT put use the borrowed funds to purchase any type of tax-exempt securities (exempt bonds, exempt money markets accounts, etc.). The loan interest is not deductible at all. IRC 265; Reg. 1.212-1(i).

7. Deduct interest on home equity loans used for business purchases on a business schedule. If you use a home equity loan for business purposes (such as the purchase of business equipment or rental real estate) the interest can be
deducted on Schedule A -- Itemized Deductions as home mortgage interest. However, if you use all or part of a home equity loan for your business, you can instead elect to treat the home equity interest as business and then deduct the interest as business interest on a business or rental property schedule (not Schedule A). Deductions on these schedules are more valuable. To do this you must make a separate written election and attach it to your return, Reg. 1.163-10T (0) (5). See next page a blank format and the following page for a sample filled-in format.

**LEGAL TIP:** With a home equity loan cash-out, deposit the funds in a business account with a *different bank* from the bank that lent you the money. *Reason:* In the event of your default, the lending bank may be able to easily lien those funds in their accounts. Even better try not to default at all.

### G. STATEMENT TO RECLASSIFY RESIDENCE INTEREST AS BUSINESS INTEREST – BLANK FORMAT

Complete and attach to IRS form 1065 (or other business or rental property schedule) the statement below when you use a home equity loan for business reasons.

____________________________________________________________

**ELECTION UNDER 1.163-10T(0) (5)**

**TO TREAT DEBT AS NOT BEING SECURED* BY A QUALIFIED RESIDENCE, BUT INSTEAD AS A BUSINESS DEDUCTION ON SCHEDULE ______**

**TAXPAYER:** ________________________________

**SS NO.** _____-____-______  **TAX YEAR:** 20____

An election is made under the provisions of Regulation 1.163-10T(0)(5) to treat debt for this taxable year and all subsequent years as not being secured* by a "qualified residence." The proceeds of such a debt are allocable to the taxpayer's business, according to the provisions of Regulation 1.163-8T. Therefore, interest paid on such debt will be deducted on Schedule ________.

**Debts For Which Election Was Made**

<table>
<thead>
<tr>
<th>Description of</th>
<th>Amount of</th>
<th>Term of</th>
<th>Interest</th>
<th>Interest</th>
</tr>
</thead>
</table>
SIGNATURES:
Principal, Partner or Member ______________________________Date_____________

*NOTE TO USER: The loan is still actually secured by the home. The above statement saying that it is not, is only for the purpose of this written tax election.

G-1. SAMPLE STATEMENT TO RECLASSIFY RESIDENCE INTEREST -AS BUSINESS INTEREST – SAMPLE FILLED-ON FORMAT

Complete and attach to IRS form 1065 (or other business or rental property schedule) the statement below when you use a home equity loan for business reasons.

ELECTION UNDER 1.163-10T(0) (5)
TO TREAT DEBT AS NOT BEING SECURED* BY A QUALIFIED RESIDENCE, BUT INSTEAD AS A BUSINESS DEDUCTION ON IRS FORM 1065

TAXPAYER: RHONDA INVESTOR

SS NO. 999_ - 99_ - 9999 TAX YEAR: 20XX

An election is made under the provisions of Regulation 1.163-10T(0)(5) to treat debt for this taxable year and all subsequent years as not being secured* by a "qualified residence." The proceeds of such a debt are allocable to the taxpayer's
business, according to the provisions of Regulation 1.163-8T. Therefore, interest paid on such debt will be deducted on IRS Form 1065.

### Debts For Which Election Was Made

<table>
<thead>
<tr>
<th>Lender</th>
<th>Description of Debt</th>
<th>Amount of Debt</th>
<th>Term of Debt</th>
<th>Interest Rate</th>
<th>Interest Amount (first yr.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABC Bank</td>
<td>Business debt</td>
<td>$30,000</td>
<td>15 Yrs.</td>
<td>10%</td>
<td>$3,000</td>
</tr>
</tbody>
</table>

SIGNATURES:

Partner or Member: **Rhonda Investor**  
Date: **10/1/20XX**

Reference Source (return tab): **SAP 8**

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
More Tax Savings With Overlooked Deductions For Real Estate Entrepreneurs

Real estate investors can increase the return on their real estate holdings by increasing the tax savings generated from these properties. One way to increment tax savings is to find overlooked deductions.

In this chapter we will discuss...

A. CHECKLIST OF FREQUENTLY OVERLOOKED DEDUCTIONS – OVERHEAD EXPENSES

B. FURTHER DISCUSSION OF OVERLOOKED DEDUCTIONS

C. MORE DEDUCTIONS

D. HOW AND WHERE TO DEDUCT THESE BUSINESS EXPENSES

A. CHECKLIST OF FREQUENTLY OVERLOOKED DEDUCTIONS – OVERHEAD EXPENSES

Besides the powerful Goldmine componentizing deductions of component depreciation, deducting replaced components, first-year expensing, and repairs; there are deductible expenses that are often overlooked. They are also called “overhead” expenses because they pertain to the entire real estate operation, not just any one property. Some of these overlooked deductions follow:

_____Auto expenses**
_____Entertainment**
_____Telephone, internet**
_____Office-in-home**
_____Office equipment & furnishings within the home office**
Office supplies, stationery, postage, etc.**
Family members on payroll**
Family “Fringes” such as a Medical Reimbursement Plan under IRC 105(b)**

[**For a further discussion of the above deductions, refer to my Tax Bible audio CD series, Power-House Tax Strategies For Self-Employed Entrepreneurs.]

Travel out-of-town (discussed in the next chapter and in the above Tax bible CD’s).

The following listed deductions are further discussed in this chapter.

1. Books on real estate and related topics
2. Subscriptions to real estate and business magazines
3. Tools & supplies
4. Equipment rental
5. Eviction costs
6. Professional fees
7. Dues for investor groups or associations

The above are deducted as ordinary and necessary expenses under IRC 162.

Tuition for real estate courses, conferences, boot camps, cruises are discussed in part C.

B. FURTHER DISCUSSION OF OVERLOOKED DEDUCTIONS

Below is a further discussion of deductions from the previous page.

1. Books on Real Estate and related topics - Included here would be books on real estate investing, finance, law, taxation, and any other related topic on real estate. Regulation 1.162-5. Books on taxes are also deductible under Regulation 1.212-1(l).
2. **Subscriptions to magazines, newsletters, etc. on real estate and related topics.** The deductibility of these items would be the same as above.

3. **Tools and supplies** - Small tools purchased to keep the property in repair should be fully deductible under IRC 162. Supplies would include hardware supplies, flashlights, locks, keys, etc. However, larger capital outlays, whose life extends beyond one year, would be depreciated over 5 or 7 years*.

   *Strategy:* Fully deduct the above items under Section 179 first-year expensing. See Chapter 13 for a further discussion of Section 179 deductions.

4. **Equipment rental** - Such as renting a machine to shampoo the carpets of a rental property is deductible under IRC 162.

5. **Eviction costs** - Such as attorney fees and court costs, as well as travel and other costs in relation to the eviction are deductible under IRC 162.

6. **Professional Fees** - Legal fees and other related expenses (such as court costs) are deductible provided they are ordinary and necessary expenses of a taxpayer’s business (IRC 162); or incurred in the management, conservation or maintenance of property held for the production of income (IRC 212). Thus, legal fees to evict tenants and prepare leases would generally be fully deductible. However, if the lease would extend more than one year, then the legal fees are written off over the term of the lease. In addition, legal fees incurred for the purchase of real estate are added to the basis of the property, Reg. 1.263(a) 2(c). (Alternatively, they may be deductible as “loan costs”, see Chapter 10).
The expenses of tax advice are generally fully deductible, Reg. 1.212-1(1). This is so even if the advice does not provide tax savings, \textit{Ippolito}, TC Memo 1965-167. Tax advice has been deductible even on the acquisition of real estate, \textit{Collin}, (1970) 54 TC 1656(A).

\textbf{Strategy:} Professionals (such as attorneys or accountants) who give tax advice should clearly indicate so on their bill. This portion would then be deductible as “tax advice”. For example, if an attorney is engaged on the purchase of real estate, then their fee will be added to the basis of the property or be considered an amortizable loan cost. However, if the attorney gives any tax advice, then they should allocate the amount of that tax advice on their invoice. (See IRS Revenue Ruling 92-29). You then fully deduct the tax advice.

7. \textbf{Dues for investor groups or associations} - Knowledge is a vital asset in owning and managing real estate. There are investor groups throughout the entire country who have workshops and guest speakers on just about every real estate topic. I highly recommend that real estate investors join these groups so they could attain this knowledge and network with other investors. This is a directly related deduction.

\textbf{C. MORE DEDUCTIONS}

For more deductions refer to our special report, \textit{400+ Tax Deductions For RE Entrepreneurs} (400+). If you do not have it, go to the Goldmine Member Only Web Site – \url{www.goldminevipaccess.com} under “Downloads”. To enroll click the box, “Members Sign In”, User Name - “goldminestudent” as one work all lowercase.

\textbf{D. HOW AND WHERE TO DEDUCT THESE BUSINESS EXPENSES}
1. Do NOT deduct on Schedule A of your 1040.

2. Deduct these expenses on your rental property or business schedules. These IRS schedules include the following: For real estate, Schedule E, or the preferred partnership return - form 1065. For other businesses, sole proprietor - Schedule C; or corporate business return - form 1120 for a C-corporation, or 1120S for an S-corporation.

3. The best IRS form for deducting these overhead expenses for real estate is - partnership 1065, not Schedule E. For real estate these type expenses are “overhead” expenses that pertain to the entire real estate operation instead of just one property (such as utilities). 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. Forming an LLC adds the limited liability protection to the tax-favored partnership (1065) and enhances deductibility per part C-1 of this chapter.

4. Expense description on IRS forms. If any of these IRS schedules do not have a designated line for the expense, attach a separate schedule - “other deductions” on which you insert the amount and specific expense description (such as the above very specific description for real estate courses - “Directly related real estate continuing business education under IRC 162”). Again, an LLC with form 1065 (partnership) is best.

Reference Source (return tab): SAP 9, Part A
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Deducting Travel To Look After Or Search For Investment Properties

A. TRAVEL TO LOOK AFTER (MANAGE) PROPERTY ALREADY OWNED BY THE INVESTOR OR TO SEARCH FOR NEW PROPERTY

B. SUPPORTING DOCUMENTATION

A. TRAVEL TO LOOK AFTER (MANAGE) PROPERTY ALREADY OWNED BY THE INVESTOR OR TO SEARCH FOR NEW PROPERTY

1. Deductible with the right documentation. With the right documentation (as discussed in this chapter) such expenses should be deductible, Mayer, TC Memo 61361; McBee, TC Memo 1965-180.

2. Travel to and from destination must primarily be for business. However, if a taxpayer travels to a destination and while there engages in both business and personal activities, traveling expenses to and from the destination (example, air fare) are deductible only if the primary purpose of the trip is business related. For travel within the U.S., it’s an all or nothing test. That is, if the trip is primarily personal in nature, the traveling expenses
(example - air fare) to and from the destination is not deductible, even though the taxpayer engages in business activities while at such destination.

3. The principal criterion for determining whether a trip is primarily business or primarily personal is the amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on business activities. As a guideline, the regulation gives an example - If a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional 5 weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary, Reg.1.162-2 (b)(2). As another guideline, in one case travel was primarily for personal reasons where 2 days of a 7 day; and 1 day of an 8 day trip were spent on business matters, Fairley, TC Memo 1982-219.

**Strategy:** Document 51% of the time for business travel, then you can deduct the entire travel to and from the destination.

4. Expenses at the destination are prorated. However, expenses while at the destination (such as hotel and meals) are deductible, even though the traveling expense to and from the destination (2 above) are not deductible, Reg. 1.162-2 (b)(1).

**B. SUPPORTING DOCUMENTATION**

**Thoroughly document your travel.** Both IRS agents and the tax courts can be very difficult in allowing travel deductions. Accordingly, documentation is essential substantiating dates, amounts, time spent on business, place and business purpose. Some planning strategies:
1. Document you are already in the real estate business by presently owning investment property. There is substantial authority to support that the ownership of real estate (even one property) is an existing trade or business. See Elek (1958, 30 TC 731 (A); IRS Letter Ruling 7931008; Jephson (1938) 37 BTA 1117. (See also Goldmine Chapter 3)

1A. Business entity - LLC. If you do not yet own property, then having a properly structured LLC should support the travel deduction (even if you own property you certainly should have an LLC). Travel should be fully deductible with a properly structured LLC, even if you do yet own real estate. When you have a business entity (such as an LLC) that is already established to be in the real estate investing business, you are in effect in the real estate business even if you do not yet own any properties. This will happen when this legal entity (LLC), via its nuclear legal document, a properly structured Operating Agreement (OA), is authorizing the company to be already in the real estate business. Accordingly, based on this legal authorization, travel expenses are ongoing ordinary & necessary expenses under Internal Revenue Code Section 162 and therefore should be fully deductible. (See Ch. 23, part C-1 for a further discussion).

1B. Start-up expenses. If you do not yet own property or do not have a properly structured LLC already set up, then travel and other related expenses should be considered start-up or investigation expenses, IRC 195. Here you can deduct, all in one year, up to $5,000 of start-up expenditures in the tax year the business begins (with the purchase of your first investment property. For start-up and organization expenditures over $5,000 must be amortized over 15 years. See Chapter 10-A for a further discussion of start-up expenses.

2. Demonstrate pre-intent before you even leave for the trip. Beforehand, compile a list of real estate agents, builders, associates, suppliers, and other pertinent contacts. Call, email or fax to make contact and set up appointments. Confirm calls by email or fax.
3. **Documentation.** Keep a copy of the phone bills, emails, faxes, etc. in your “Travel File”. Take your Daytimer or Palm Pilot with you and document all of your business activities in detail.

4. **Business itinerary.** While traveling to the destination, write up a proposed detailed business itinerary of the trip.

5. **More documentation.** When returning, document the results of the trip, including new contacts, new ideas, what follow-up you will do, etc.

6. **Documentation chart.** Below is a quick chart to use as a guide to ascertain the documentation needed to substantiate travel deductions.

<table>
<thead>
<tr>
<th>ITEM</th>
<th>DOCUMENTATION</th>
</tr>
</thead>
</table>
| DATES & PLACE | Seminar literature, air line tickets  
 hotel bill, correspondence |
| EXPENSES | Statements, receipts, Daytimer |
| TIME SPENT* ON BUSINESS & BUSINESS PURPOSE | Daytimer, Palm Pilot, business agenda, seminar sales literature, correspondence, reports, phone bills, client files, etc. |

*REMINDER: To secure full deductions for travel to and from the destination, you must prove at least 51% of your travel was business related. For a further discussion of travel deductions, refer to my audio CD series, *Power-House Tax Strategies For Self-Employed Entrepreneurs* (the “Tax Bible”).

**REMINDER: Use a business entity – an LLC.** A properly structured LLC with complete LLC forms (esp. the operating agreement) can also document and support your travel expenses as per the above.
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours
invested to research and create this intellectual work and our rights to this material. No part of
this program may be sold (including on the internet), transferred, reproduced by any means,
stored in any information retrieval system or transmitted in any form or by any means without
the specific written permission of ISU. Legal action will be brought against you and/or your
company if you are found to have made ANY unauthorized copies of these materials, in part or
in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you
make a profit or not, you are committing a serious copyright infringement crime, punishable by
severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Deducting Real Estate Taxes And Special Assessments

Reference Source (return tab): SAP 9A

In this chapter we cover the following...

A. REAL ESTATE PROPERTY TAXES - DEDUCTIBLE
B. REAL ESTATE BACK TAXES - ADDED TO BASIS
C. SPECIAL ASSESSMENTS ADDED TO BASIS
D. STRATEGIES FOR SPECIAL ASSESSMENTS

A. REAL ESTATE PROPERTY TAXES - DEDUCTIBLE

Real property taxes that are the liability of the taxpayer are fully deductible as a rental property expense. IRC 164(a)(1).
B. REAL ESTATE BACK TAXES - ADDED TO BASIS

The buyer’s payment of the seller’s back taxes are not deductible in the first year. They are added to the cost basis of the property. You recover the deduction through depreciation deductions on the property’s basis and/or when you sell the property. IRC 164(c)(2).

**NOTE**: As a practical matter if the back taxes are on the settlement (HUD1) sheet I have seen investors fully deduct the taxes. I remember when at a tax seminar, a fine CPA (teaching the seminar) said to deduct the back taxes if they are on the settlement (HUD1) sheet. Not technically correct; I am not recommending it; but do what you want.

C. SPECIAL ASSESSMENTS ADDED TO BASIS

These are additional charges imposed by local government for improvements such as the installation of streets, sidewalks, sewers and other like improvements measured by some benefit that inures directly to the property against which the assessment is levied, Reg. 1.164-4(a). The cost of these types of assessments is not currently deductible, but instead added to the basis of the property, IRC 164(c)(1).

Examples of special assessments (added to basis) are:
1. “Front-foot benefit charges” assessed by a sanitary commission for water main and sewer improvements, Revenue Rulings 75-455 and 79-201.

2. Taxes imposed by a municipal authority utility district where the property subject to the taxes is limited to the property benefited, Revenue Ruling 76-45.

3. A one-time fee charged for hooking into and the right to use a municipal sewer system for an indefinite period (but the monthly service charges are fully deductible as a property expense), Noble 70 TC 916.

**D. STRATEGIES FOR SPECIAL ASSESSMENTS**

1. **Adding to basis benefits.** These special assessments are added to the property basis and therefore will reduce gain (or increase loss) upon the disposition of the property. They also are depreciable, RR 73-188; Loveman & Son Export Corp., 34 TC 776, aff’d, 296 F.2d 731. Moreover, most of them should be depreciated over 15 years as “land improvements”. See Chapter 12-B for a further discussion.

2. **A full deduction is allowed for the maintenance and repairs of the improvement as well as for any interest paid.**

   The taxpayer must show a separate allocation* to the maintenance, repairs or interest, Reg. 1.164-4(b).
*TIP*: Have the taxing authority separate these charges on the tax bill, Revenue Ruling 79-201.

Reference Source (return tab): SAP 9A
How To Deduct Real Estate Education Seminars, Boot Camps, Courses

Reference Source: SAP 9, Part B

In this chapter we cover the following...

A. EDUCATION EXPENSES AND TRAVEL FOR REAL ESTATE COURSES, BOOT CAMPS AND CRUISES ARE FULLY DEDUCTIBLE

B. FULLY DEDUCTIBLE WITH A PROPERLY STRUCTURED LLC, EVEN IF YOU DO NOT OWN REAL ESTATE

C. DEDUCTING EDUCATION AND TRAVEL EXPENSES INCURRED BY YOU BEFORE THE LLC FORMATION, NOT YET OWNING PROPERTY.

D. HOW AND WHERE DEDUCTED

A. EDUCATION EXPENSES AND TRAVEL FOR REAL ESTATE COURSES, BOOT CAMPS AND CRUISES ARE FULLY DEDUCTIBLE
1. Beware of wrong advice from national speakers and tax advisors!
If you own investment real estate, you can deduct these real estate courses as well as conventions, seminars, boot camps, cruises. These are often big ticket deductions; so read on.

2. Tax law support:

(a) **Background & misunderstanding** - According to Internal Revenue Code Section 274(h)(7), “No deduction shall be allowed under section 212 for expenses allocable to a convention, seminar or similar meeting.” This very short clause has caused many people (including speakers and tax advisors) to misinterpret this as meaning that real estate investors cannot deduct expenses for a convention, seminar, similar meeting or even home-study courses.

(b) **Section 162 v. 212** - But the key wording in the above provision is “Section 212”, which has to do with the production of more passive income, such as that from stocks or bonds. This is opposed to Internal Revenue Code Section 162 which has to do with a trade or business, such as real estate. Under IRC 162, such expenses are fully deductible.

(c) **Real estate is a business** - The question is this -- Is the ownership of real estate an *investment* (Section 212), or is it a *business* (Section 162)? There is substantial authority to support that the ownership of real estate (even one property) is a *business* under IRC 162. Accordingly, being in the real estate *business*, you can deduct these home-study courses, conventions, seminars, boot camps, etc. under IRC 162 and IRS Regulation 1.162-5 a)(1).
(For tax law authority supporting real estate as a “business” vs. “investment”, see Chapter 3. For deducting cruise conventions, refer to our special report on disk, SR4CRDED).

(d) Tax advice is deductible. Plus for tax courses (tax advice) there is further support in that expenses paid for tax advice are deductible as per Regulation 1.212-1(l).

3. How to deduct. Deduct these courses on the applicable IRS schedule with the following specific description - “Directly related real estate continuing business education under IRC 162”.


B. EDUCATION EXPENSES AND RELATED TRAVEL SHOULD BE FULLY DEDUCTIBLE WITH A PROPERLY STRUCTURED LLC, EVEN IF YOU DO YET OWN REAL ESTATE

With an LLC there already is a business. However, as opposed to an unincorporated taxpayer, if you have a business corporate-like entity (such as an LLC) that is already established to be in the real estate investing business by way of a properly structured* Operating Agreement (OA). That is, this legal entity (LLC), via this legal document (the OA), is authorizing the company to be already in the real estate business. Accordingly, based on this legal
authorization, the above education expenses (and related travel) are ongoing ordinary & necessary expenses under Internal Revenue Code Section 162 and therefore should be fully deductible, even if you do not yet own any properties. (*Note: The LLC operating agreement must have the correct provisions and wording to accomplish the above full deduction of the above expenses. See below for more info*).

*MORE INFO: For more information on setting up real estate LLC’s with the correct documents (including a powerful 121 page real estate LLC operating agreement), refer to the new course, The LLC Master Machine Forms Package by Albert Aiello, CPA, MS Taxation with William Noll, Esquire. For more details go to www.LLCProtectYou.com. Or call us at 215-271-1998.

C. DEDUCTING EDUCATION AND TRAVEL EXPENSES INCURRED BY YOU BEFORE THE LLC FORMATION, NOT YET OWNING PROPERTY.

To do this - have the LLC reimburse you the expenses under an accountable plan per Regulation 1.62-2(c). The LLC-partnership gets the deduction for the expenses, not you (directly), such as if you would have taken them on the very audit prone schedule C or E. You ultimately get the benefit of the deduction because the expenses will lower the LLC-partnership net income or increase its net loss, with either one (lower income or higher loss) flowing through to your 1040. Alternatively, the LLC-partnership can purchase any educational materials from you where you previously had purchased them on your own. Again, the LLC-partnership gets the deduction for the expenses
per the above. You would offset the sale by the cost of the materials so it becomes a wash to you, personally on your 1040. If the LLC does not have the cash to pay you, then take a promissory note (credit) from the LLC with the LLC still getting the deduction as per the above. Make sure the note is eventually paid off by the LLC to you; the sooner the better.

D. HOW AND WHERE DEDUCTED

“Directly related business education per IRC 162” on your own separate supporting schedule to line 20 (other deductions), page 1 of form 1065

Reference Source: SAP 9, Part B
A. REAL ESTATE INVESTMENTS - THE BEST OF ALL WORLDS

B. PASSIVE LOSS LIMITATIONS OF THE 1986 TAX REFORM ACT [IRC 469]

C. IT IS IMPORTANT TO UNDERSTAND THAT EVEN WITH THESE PASSIVE LOSS LIMITS, REAL ESTATE CAN STILL BE A VERY PROFITABLE INVESTMENT AND AN EXCELLENT TAX SHELTER

A. REAL ESTATE INVESTMENTS - THE BEST OF ALL WORLDS

As discussed in Chapter 1, one of the unique, magical virtues of real estate investments is that a property can be financially profitable with a positive cash flow, yet still show a paper tax loss. As it was discussed in Chapter 1 the paper loss offsets other types of income and generates tax savings and additional cash flow.
The passive loss limitations attempt to put a limit on doing the above - deducting losses against other types of income. However, as discussed in the ensuing sections, there are exceptions and planning strategies to reduce or eliminate these limitations.

B. PASSIVE LOSS LIMITATIONS OF THE 1986 TAX REFORM ACT [IRC 469]

1. What Are These Limitations: The TRA of 1986 instituted provisions which many experts believe to be unfair to real estate and a major contributor to the economic turnaround in the late 1980’s and early 90’s. These provisions are called the “passive loss” limitations pertaining to rental property activities. Under these rules, tax losses from owning rental property (e.g. Schedule E losses) are passive losses and can only be deducted against net income in the same category, passive income, which is net taxable rentals and gains from rental property activities. No current deduction for these losses is allowed against other types of income, namely what is called “active” income and “portfolio” income. Active income includes salaries, fees, commissions, net business income. Portfolio income includes interest, dividends, annuity income, certain royalty income and gains on the sale of assets that generate the above type of portfolio income. Passive Activity Loss Limitations are referred to as “PAL” (which they certainly are not.)

2. PAL Pertains To These Types of Activities: All rental real estate activities are considered passive activities [IRC 469(a) and (b)], unless the taxpayer
comes under one of several exceptions, discussed in Part 1 of Appendix B (PAPPB) as well as the exception for active real estate businesses, discussed in Chapter 26.

3. PAL Also Pertains To Tax Credits: Besides rental property losses, rehabilitation and low-income housing tax credits are also subject to these passive loss limits, IRC 469(a); 469(d). However, they do get some relief from these limits as discussed in Chapters 20 & 21.

4. PAL Does Not Pertain To These Types of Activities: The following activities are not subject these passive loss limits: (1) Hotel\motel operations or other similar transient lodging where substantial services are provided (discussed in Appendix B; (2) Dealer activities in real estate; and (3) Real estate professional investors materially participating in the management of the property (discussed in Chapter 26). Also, PAL limitations do not pertain to deducting the business use of a home via home office deductions as per IRC 280A(c)(5) [see IRC 469(j)(10)]. They do not apply to personal and business casualty losses, such as fire, flood, storm or theft losses, Reg. 1.469-2T(d)(2)(xi). For raw land, see Appendix B.

5. PAL Pertains To These Types of Ownership\Entities and Their Members: The passive loss provisions apply to individuals, estates and trusts regardless of whether they engage in a passive activity directly or through a partnership, LLC or an S-corp, IRC 469(a)(2)(A). Thus, for pass-through entities such as general partnerships, limited partnerships, LLC-partnerships and S-corps, the PAL limitations are applied individually to each partner, member or shareholder. (This is discussed in the next chapter and Appendix B.

5A. C-corps are also subject to PAL limitations, IRC 469(a)(2)(B). However, C-corps receive some relief in that their passive losses can offset other active business income, but not “portfolio” income (such as interest and
dividends), IRC 469(e)(2). (Note: In any event C-corps are not good ownership entities for rental properties as per Chapter 5-A.)

5B. Partners in a Partnership or LLC Members: General partners or LLC members are subject to PAL limitations, but can reduce or bypass them with either the exceptions of the $25,000 loss allowance (Chapter 25); or fully deducting losses without limit by being a real estate professional (Chapter 26). However, limited partners in a limited partnership are subject to PAL limitations, without use of these exceptions, IRC 469(h)(2).

6. Tax Break - Suspended or Unused Losses: The disallowed excess losses or credits are not lost forever. They become unused rental property tax losses, called “suspended” losses.

These losses can be carried forward indefinitely (but not carried back) until other passive income can be generated, IRC 469(b). (Note: The tax savings from the excess rental losses are also suspended.) The suspended losses can then be used as a deduction against passive income, which includes net taxable rental income and gains from property sales. Thus, any accumulated suspended losses for a property can be later used to offset the gain on the sale of the property to an unrelated party (discussed in the next chapter.)

Another Tax Break: There are exceptions and planning strategies to partially, or totally bypass these loss limits (discussed in Chapters 25, 25-A and 26).

C. IT IS IMPORTANT TO UNDERSTAND THAT EVEN WITH THESE PASSIVE LOSS LIMITS, REAL
Immediate tax savings from rental property losses is only one of several potential sources. These other sources are: (1) *Net cash flow from rentals* (plus many other potential sources of property income); (2) *Equity accumulation from principal amortization* on the mortgage (paid by the tenants via rents); and (3) *Equity accumulation from increases in property value* (which can be achieved through the creative efforts of the property owner). Because of these other significant sources, even without the benefit of immediate tax savings from rental property losses, real estate investments can still reap substantial profits and yields.

**Still Tax-Free Cash Flow:** That is, *rental property deductions* (including componentizing) can still totally shelter current income from the property, allowing the investment to generate tax-free cash flow. (This was illustrated in Chapter 1).

**Real Estate Losses Offset Real Estate Income:** Moreover, excess tax losses of one rental activity can offset taxable income of other rental investments. Accordingly, while you may not reap immediate tax savings from loss offsets against *other* income, you can still pocket tax savings from offsets to rental property income. You therefore still have at least some tax savings as a fourth source of return on your investment.

**Loss Carryforwards:** Also, the disallowed excess losses are not lost forever. You can carry them forward to offset future passive rental income and gains (as discussed in Chapter 25-A).
Use The Goldmine To Fully And Currently Deduct Losses: Of course if you follow the strategies of the Goldmine, you could side step passive loss limitations. These strategies are discussed in the ensuing Chapters.
In this chapter we will discuss...

Reference Source (return tab): **SAP 10**

---

**A. REQUIREMENTS FOR THE $25,000 LOSS EXCEPTION**

1. *RENTAL* REAL ESTATE  
2. *INDIVIDUAL* TAXPAYER  
3. ACTIVE PARTICIPATION  
4. ADJUSTED GROSS INCOME (AGI) BELOW CERTAIN AMOUNTS  
5. AT LEAST A 10% OWNERSHIP  
6. NOT A LIMITED PARTNER

**B. EXAMPLES - MEETING THE ABOVE REQUIREMENTS FOR THE $25,000 LOSS DEDUCTION**

**C. ALERT ON THE ORDER OF DEDUCTING THE $25,000 LOSS DEDUCTION**

**D. THE $25,000 LOSS ALLOWANCE ALSO PERTAINS TO TAX CREDITS**
A. REQUIREMENTS FOR THE $25,000 LOSS EXCEPTION

To spell some relief for smaller investors, TRA of 1986 enacted this exception to the above passive loss limits: Investors can annually deduct up to $25,000 of rental property tax losses against any other types of income - salaries, fees, commissions, interest, dividends, etc, IRC 469(i). The $25,000 is per taxpayer, per year. It is not for each rental property owned. It is also per tax return. Husband and wife on a joint return are entitled to only one $25,000 loss. For married filing separately returns, the $25,000 is reduced to $12,500 for each spouse, provided spouses live separately* from each other for the entire year.

*TAX TRAP: If married couples, filing separately, live together at any time during the year, the $25,000 loss exception is zero. That is, in this scenario, either husband or wife will not be entitled to any property loss deductions. IRC 469(i)(5)(B). Monroe, TC 2002-79.

TIP: File jointly. It is usually more advantageous under most circumstances.

STRATEGY 1: Meet the six requirements to come under the $25,000 loss exception - To be entitled to the $25,000 loss exception, all of the following 6 tests must be met:

1. RENTAL REAL ESTATE
2. INDIVIDUAL TAXPAYER
3. ACTIVE PARTICIPATION
4. ADJUSTED GROSS INCOME (AGI) BELOW CERTAIN AMOUNTS
5. AT LEAST A 10% OWNERSHIP
6. NOT A LIMITED PARTNER
These tests are further discussed as follows.

**TEST 1. RENTAL REAL ESTATE:** The property must be for rental real estate where rent payments are for the use of real property (as opposed to services). Therefore rental houses, rental condos, apartment buildings, commercial properties, etc. are included here, IRC 469(i)(1). Not rental real estate (and not eligible for the $25,000 loss allowance) would be hotel/motel operations or other similar transient lodging where substantial services are provided. Generally, included here are vacation-home rental pools. [See Appendix B (PAPPB) for a further discussion of these and other activities that are not considered a rental real estate activity and not eligible for the $25,000 loss allowance; but are generally eligible for the full deduction of rental property losses via the active real estate business, per Chapter 26.]

**TEST 2. INDIVIDUAL TAXPAYER:** The investor must be an individual taxpayer and not a corporation, IRC 469(i). General partners and LLC active members are entitled to the $25,000 loss allowance on an individual per-partner or per member basis and not a per-partnership or per LLC entity basis. (Limited partners are not at all entitled to the $25,000 loss allowance.) Non-grantor irrevocable trusts* also do not qualify for the $25,000 loss exception. *The rationale here is to prevent individuals from making use of multiple $25,000 limits by placing each property in a separate trust.

*NOTE: Individuals sometimes use land trusts or living trusts for reasons of privacy or for avoiding probate. Such grantor type trusts should not prevent the investor from qualifying for the $25,000 loss, provided that the underlying taxpayer is still an individual or a general partner, or LLC active member using only one $25,000 loss allowance. The same would apply to active members in an LLC and to grantor irrevocable trusts. Estates may qualify, see test 3, next.
**TEST 3. ACTIVE PARTICIPATION:** The investor must “actively participate” in the management of the property, IRC 469(i)(6). With “active participation”, the investor does not have to manage on a continuous basis (as with “material participation”, covered in the next chapter). However, the investor must perform the duties of normal landlord -- approve new tenants, decide on rental terms, review property expenditures, and all the other facets of good property management (which investors should do anyway). For a list of excellent property management publications, see the end of Chapter 26.

For Estates: If the decedent actively participated in the management of the property, the estate is considered to be active for the two years following the death of the taxpayer, IRC 469(I)(4). Presumably after two years - no.

**TAX BREAK WITH SPOUSES:** Management functions performed by the investor’s spouse are also considered to be those of the investor in meeting this requirement, IRC 469(i)(6)(D).

**EXAMPLE 1:** Husband and wife, John and Mary, own rental real estate. Only Mary actively manages the property. John is too busy. Assuming they meet the other requirements, the couple will still be able to fully deduct up to $25,000 of rental property tax losses against their other income of salaries, interest, etc. **Reason:** Management functions performed by the investor’s spouse are considered to be those of the investor in meeting this requirement of actively managing the property.

**TAX ALERT:** When using the management company (either an outside one or your own separate company) the investor should have a definite final say on at least the more important management decisions. But the more say the better.

**STRATEGY ON MANAGEMENT CONTRACT:** You should have a management contract with the management company (either an outside one or your own separate company) that includes this clause: “Principal (investor)
must give final approval on all new tenants, rental terms, property expenditures that exceed $100 (or whatever) and any other major management decisions affecting the property.”

EXAMPLE 2: Same facts as above, except neither John nor Mary manage the property. Instead they hire a management company to manage their property. However, the management contract incorporates a clause that states John or Mary have a final say on any major decision affecting the property. They will be able to fully deduct the $22,000 rental tax loss against their other income of salaries, interest, etc. Reason: Using a rental management company will generally not prevent investors from meeting this test (for the purposes of this $25,000 exception), provided that the investor has a definite “final say” on at least the more important decisions.

EXAMPLE 3: Same facts as the above, except John & Mary have no say in the management of their property. Here, they will be not able to fully deduct the $22,000 rental tax loss against their other income of salaries, interest, etc. Tax Law Support: A real estate investor was totally subject to the PAL limitations because the management company handled all of the affairs of the investor’s real estate, Madler vs. Commissioner, TC Memo 112, 1998. (Emphasis added to “all”). Follow these Goldmine strategies.

**TAX BREAK:** For rehabilitation tax credits (IRC 47) and low-income housing tax credits (IRC 42), there is no active participation requirement, IRC 469(i)(6)(B). Therefore, such credits in a limited partnership can qualify for the $25,000 loss allowance (in deduction-equivalent credits, discussed in Appendix B.

**TAX ALERT -- NET LEASE PROPERTIES & HOTEL-CONDOS:** Because the tenant is responsible for almost all operating and maintenance costs, the property owner will be more passive and therefore may not meet this active requirement for reaping the $25,000 loss allowance. Hotel-condos also
may have difficulty meeting this active requirement. For a further discussion, see Appendix B.

**TEST 4. ADJUSTED GROSS INCOME (AGI) BELOW CERTAIN AMOUNTS:** The investor’s adjusted gross income (AGI) (not including losses from rental properties) must be $100,000 or less. The $25,000 loss exception is reduced by 50% of the investor’s AGI in excess of $100,000 up to $150,000. After $150,000* of AGI, the $25,000 phases out completely and there is no current loss deduction at all against other types of income, IRC 469(i)(3)(A). In the latter situation, all losses will become suspended and carried forward, as previously discussed. (For a schedule of the phase out of the $25,000 passive loss limit for AGI between $100,000 and $150,000, see Appendix B (PAPPB).

*TAX BREAK: For rehabilitation tax credits to older or historic properties (IRC 47), the maximum AGI is increased to $250,000 for the $25,000 loss exception (in deduction-equivalent credits), IRC 469(i)(3)(B). For a further discussion of rehab tax credits, see Chapter 20.

*BIGGER TAX BREAK: For low-income housing credits (IRC 42), there is no maximum AGI, IRC 469(i)(3)(C). Therefore, for the purposes of claiming low income housing credits, the investor can make any amount of income. For a further discussion of low-income housing tax credits, see Chapter 21.

**ALERT ON WHAT IS “AGI”:** Unfortunately, for the purposes of this provision, AGI is not reduced by the passive losses themselves and IRA contributions, IRC 469(i)(3)(E).

**AGI TAX BREAK:** However, for the purposes of this provision, AGI is not increased for taxable social security benefits and interest income from Series EE savings bonds used to pay for higher education, IRC 469(i)(3)(E). Moreover, AGI can be reduced by qualified (Keogh), SEP or SIMPLE retirement plan contributions, as well as other deductions to arrive at AGI, such
as student loan interest, medical savings account deductions, moving expenses, one-half of self-employment tax, self-employed health insurance deduction and penalties on the early withdrawal of savings. These deductions begin on about line 24, page 1 of IRS Form 1040.

**STRATEGY**: Employ strategies to keep AGI low as possible, such as incurring the above AGI deductions (especially the above retirement plan deductions); or lower AGI with these income deferral/elimination strategies:

1. Postponing salary, bonuses or business income to a later year
2. Deferring income via tax deferred retirement plans
3. A 1031 exchange (see Chapters 32 to 34-A)
4. Installment sale reporting, IRC 453 (see Chapter 35)
5. The $250/$500,000 homeowner exclusions (see homeowner exclusion special reports on the ISU Member-Only-Site, www.GoldmineVIPAccess.com)

**EXAMPLE 4 - AGI**: It’s November of the current tax year and you are doing pre-year end planning. As of October 31 of the current year your AGI is $130,000 and will be $150,000 by December 31. This is without regard to rental passive losses of $25,000 and Keogh plan contributions. The projected AGI also includes a year end bonus of $35,000. To reduce this AGI, you do the following: Contribute $15,000 to your Keogh plan and hold off receiving the $35,000 bonus until the following year.

**Result**: You reduce your AGI to $100,000 and you fully deduct the $25,000 rental passive losses for the current year. (Note that this excellent outcome is a result of advanced tax reduction planning before 12/31, as opposed to April 15th compliance!)
**TEST 5. AT LEAST A 10% OWNERSHIP:** The investor (or their spouse) must own at least a 10% ownership interest in the property for the entire taxable year of the property, IRC 469(i)(6)(A).

**TAX TRAP:** If the investor (or their spouse) owns less than 10% at any time during the year, no part of the loss can be deducted. The loss is not prorated. It is suspended and carried forward as per this provision.

**EXAMPLE 5:** Mr. & Mrs. Investor own a 7% interest in rental property in which they actively participate. Later in the year they acquire another 3%, bringing their total up to 10%. They cannot deduct any part of the rental property losses because they did not own at least a 10% interest for the entire tax year. There is no prorating of the loss.

**TIP:** Acquire at least a 10% ownership interest for the entire taxable year.

**Time Shares:** Because of the very small percentage of ownership most time shares will not qualify for the $25,000 loss allowance, Toups, 66 TCM 370; Fudin, TC Memo 1994-235.

**TEST 6. NOT A LIMITED PARTNER:** The investor must not be a limited partner, IRC 469(i)(6)(C). Therefore, limited partners are not entitled to the $25,000 loss exception. *Reason:* According to state law a limited partner cannot participate in management in any way at all*.

* **TAX BREAK:** For rehabilitation and low-income housing credits, there is no active participation requirement, IRC 469(i)(6)(B). Therefore, such credits in a limited partnership can qualify for the $25,000 loss allowance (in deduction-equivalent credits).

**NOTE:** General partners and active LLC members are entitled to the $25,000 loss allowance on a per-partner or per member basis and not on a
per-partnership or per LLC entity basis, provided that the partner or member is an individual taxpayer. Unlike limited partners, active members of an LLC can participate in management without losing their limited liability status. (One reason, among several, why LLC’s are superior to LP’s).

**B. EXAMPLES - MEETING THE ABOVE REQUIREMENTS FOR THE $25,000 LOSS DEDUCTION**

**EXAMPLE 6**: John & Mary are married and own rental properties, which for the current year, will show a tax loss of $22,000. They both have full time jobs that are unrelated to real estate and are not limited partners. However, they “actively participate” in the management of the property and perform the normal duties of landlording -- approve new tenants, decide on rental terms, review property expenditures, and all the other facets of good property management (which astute investors should do anyway). Their adjusted gross income (AGI) is under $100,000 and they file a joint return. Based on these facts, they will be able to fully deduct the $22,000 rental tax loss against their other income of salaries, interest, etc. In a 31% bracket, they reap over $6,800 in immediate tax savings. **Reason**: They meet all of the tests in this section to come under the $25,000 annual active exception.

**EXAMPLE 7**: Same facts as above, except the rental property losses are $50,000. Here $25,000 is fully deductible in one year and the remaining $25,000 must be suspended and carried forward. **Reason**: Any losses above the $25,000 are suspended.
Before being used to offset other income (such as salaries, business income, interest, etc.), the $25,000 loss-deduction is applied against income in this order:

(1) Net Passive Income from rental properties in which the taxpayer actively participates. This includes gains on property sales.

(2) Other Income - After this, only the remaining amount of the $25,000 allowance (if any) can be used to offset other income, such as salaries, business income, interest, etc. (Conference Report of TRA 1986, page 141).

**EXAMPLE 8**: JI has $25,000 losses from rental real estate in which she actively participates. In the same year she sells another rental property for a $25,000 gain. JI also has $30,000 in other ordinary active and portfolio income such as salaries, business income, interest, etc. JI must use the $25,000 passive loss to offset the $25,000 gain. She has none of the $25,000 loss allowance remaining to reduce her other ordinary income (salaries, business income, interest, etc.).

**Possible taxpayer drawback with capital gain**: If the above $25,000 gain is a long-term capital gain, this ordering of deducting the $25,000 loss could be to the taxpayer’s disadvantage. Assuming a 15% federal capital gain rate, the $25,000 loss deduction against the capital gain of $25,000 is only worth 15%, because that’s what the gain would have been taxed at (under current rates). However,
against JI’s ordinary income the $25,000 loss deduction can be worth 35%, because ordinary income can be taxed higher at 35%. **This is a difference of 20% or a loss in tax savings of $5,000** ($25,000 x 20%).

**TIP 1: DEFER THE GAIN VIA A 1031 EXCHANGE** -- If JI deferred all or part of the $25,000 gain via a 1031 exchange, then the amount of the deferred gain would not be included in income and therefore would not be available for the offset of the $25,000 loss deduction. In this case JI can use the corresponding loss deduction to reduce her ordinary income at possible higher rates. The deduction is now more valuable. For example, assume JI defers the entire $25,000 gain via a 1031 exchange. Now that the gain is not included in her income, she can use the full $25,000 loss to reduce her $30,000 of ordinary income down to $5,000. (The tax savings here are at least $5,000 as discussed above). (For more about 1031 exchanges, see Chapters 32 to 34-A.)

**TIP 2: DEFER THE GAIN VIA INSTALLMENT SALE** -- Another way to defer all or part of the gain is with installment sale reporting under IRC 453. (See Chapter 35.)

**D. THE $25,000 LOSS ALLOWANCE ALSO PERTAINS TO TAX CREDITS**

The $25,000 loss-deduction allowance limit also applies to tax credits pertaining to rental real estate. Such tax credits include rehabilitation tax credits to older or historic buildings (IRC 47) and low-income housing tax credits (IRC 42). To do
this, the tax credits are converted to what the equivalent-loss-deduction would be, IRC 469(i)(1); IRC 469(j)(5).

For a further discussion on how to compute the equivalent-loss-deduction see Appendix B (PAPPB). For a further discussion of rehabilitation tax credits, see Chapter 20. For a further discussion of low-income housing tax credits, see Chapter 21.
How To Bypass Passive Loss Limits --
Sell The Entire Property and Trigger
The Use Of All Suspended Losses

Reference Source (return tab): SAP 11

In this chapter we will discuss the following related strategies...
**STRATEGY 1:** Sell the entire property to an unrelated party in a fully taxable disposition – Four tests that must be met

**STRATEGY 2:** Appreciated (“gain”) properties, carrying suspended losses, should be sold during the lifetime of the taxpayer (alert with inherited properties upon death of the property owner)

**STRATEGY 3:** In order to use the suspended losses on a sale, you must segregate each rental property as a separate “activity”

**STRATEGY 4:** ALERT ON UNUED TAX CREDITS: Unused tax credits (such as rehab and low-income housing credits) may be totally lost upon the full disposition of the property

**STRATEGY 5:** If the rental properties are showing taxable income, then flunk the tests of the relief provision allowing active real estate professionals to fully deduct rental losses without being subject to PAL limits

**STRATEGY 6:** On the other hand if the rental operations are showing losses, then totally bypass PAL limitations (per chapter 26)

**STRATEGY 7:** For more planning strategies to create passive income in order to reduce passive loss limitations, see Appendix B (PAPPB).

**STRATEGY 1** Sell the entire property to an unrelated party in a fully taxable disposition. **Reason:** All of the suspended losses on the property can now be used to offset the gain on the sale or disposition.

**The Order of Deducting The Suspended Losses:** Any losses in excess of the gain can be further used to offset income in the following order:

(1) Gains on the sale or disposition of other passive rental properties
(2) Net rental taxable income from passive rental properties
(3) Nonpassive income, including active income such as salaries or net business profits and portfolio income such as interest, dividends, etc. See IRC 469(g)(1).

EXAMPLE 1: You sell a rental property for $150,000 which has an adjusted basis of $100,000 (ignore closing costs). The gain is $50,000 ($150,000 less $100,000). The suspended losses that have been carried forward with this property are $30,000. The net taxable gain is $20,000 (total gain of $50,000 less $30,000 of suspended losses). Had the suspended losses been $60,000, there would have been no taxable gain on the sale of the property, plus a deductible loss of $10,000 which could be used to reduce, first, other net passive income or gains (if any) and then other nonpassive income such as salaries, commissions, interest, etc.

To qualify for this planning strategy, all of the following four requirements must be met:

Req. (1) The entire (100%) property must be sold, IRC 469(g)(1).

Req. (2) The property must be sold to an unrelated property and not to a “related party”, as defined in IRC 267(b) and 707(b), IRC 469(1)(B).

Req. (3) The property must be “sold” and not disposed of by gift or by reason of death, IRC 469(j)(6); IRC 469(g)(2).

Req. (4) The sale must be a taxable event, where there is the recognition of taxable gain, IRC 469(g)(1). The property transfers that are not considered fully taxable dispositions and will not trigger suspended losses:

(a) Transfers to related parties, IRC 469(g)(1)(B); (b) Transfers by gift, IRC 469(j)(6); (c) Transfers by reason of death, IRC 469(g)(2); (d) Section 1031 tax-deferred exchanges, IRC 469(g)(1); (e) Section 453 installment sales, IRC 469(g)(1), IRC 469(g)(3).
The above tests (1 through 4) are further explained:

(a) **The entire (100%) property must be sold.** While partial transfers can create some passive income (per Appendix B, Part 1), they will not trigger full use of all suspended losses.

**[TAX BREAKS:]** An abandonment of the property is generally a fully taxable disposition [IRC 165(a)] which would trigger the use of the suspended losses. (See Chapter 45)

The same for mortgage foreclosures. See Temp. Reg. 1.163-8T and RR 92-92.]

(b) **The property must be sold to an unrelated party and not to a “related party.”** A related party comes under IRC 267(b) and 707(b). IRC 267(b) includes lineal relatives -- parents, grandparents, children, grandchildren, brothers, sisters and other related parties* such as more than 50% owned corporations. IRC 707(b) includes more than 50% owned partnerships and LLC’s. [*For a list of more related parties, refer to IRC 267(b)]

**STRATEGY: Sell to an unrelated but “friendly” party.** Related parties do not include aunts, uncles, cousins, nieces, nephews, friends, 50%* or less owned partnerships, LLC’s or corporations. (*The other 50% must be owned by non-related parties). Therefore, selling the property to one of these unrelated parties will trigger the use of the suspended losses. The validity of such sales should be at an arms-length sales price & terms, with all parties being legally bound.

(c) **The property must be “sold” and not disposed of by gift or by reason of death.** If the property is gifted, the suspended losses cannot be used to reduce any passive income. Instead they are added to the basis of the gifted property. This becomes the basis to the donee. IRC 469(j)(6).
EXAMPLE 2: Mom (donor) gifts her property to daughter (donee). The property has a fair market value of $70,000 and an adjusted basis of $30,000. Suspended losses are $20,000. Mom cannot deduct the suspended losses in the year of the gift. Instead they are added to the basis of the property, now owned by the daughter. Therefore the new basis to the daughter will be $50,000 which consists of the old basis of $30,000, plus the suspended losses of $20,000. With gifting, the fair market value ($70,000) is of no consequence.

NOTE: With gifting, the use of the suspended losses is not yet wasted. It is just postponed until the property is sold in a fully taxable disposition to an unrelated party.

STRATEGY 2: Appreciated (“gain”) properties, carrying suspended losses, should be sold during the lifetime of the taxpayer. Here, suspended losses will not be wasted and can be used as a deduction against other income.

TAX TRAP -- INHERITED PROPERTY: If the property is transferred by reason of death, the suspended losses are absorbed by the amount of the basis step-up. These losses are absorbed and are lost forever and wasted, IRC 469(g)(2)(B). Any losses in excess of the step-up can be used as a deduction on the decedent’s final return, IRC 469(g)(2)(A).

EXAMPLE 3: The deceased taxpayer leaves a property with a market value of $70,000 and an adjusted basis of $20,000. The basis step-up is $50,000 or the difference between the $70,000 market value and $20,000 adjusted basis. If the deceased taxpayer had up to $50,000 of suspended losses, they would be absorbed by the $50,000 basis step-up. They would vanish and be wasted. If there were $60,000 of suspended losses, then the excess if $60,000 over $50,000, or $10,000, can be used as a deduction on the decedent’s final return. Again, the other $50,000 would be absorbed, lost forever, and wasted. So Viva! (live)
**Loss-properties can be held until death.** On the other hand, “loss” properties whose adjusted basis exceeds the property’s fair market value, can be held until death. In this situation, upon death, suspended losses will not be wasted and can be used as a deduction against other income. Other estate planning aspects should also be considered with competent advice.

(d) **The sale must be a taxable event, where there is the recognition of gain (no taxable gain = no passive income).** If there is no gain recognized (i.e. taxed), then the suspended losses are not triggered and cannot be used to offset passive income, IRC 469(g)(1).

(1) **1031 Exchanges:** For example, with a totally tax-deferred exchange under IRC 1031, there is no taxable gain. Therefore, suspended losses will not be triggered. However, to the extent that there is recognized taxable gain in a generally tax-deferred transaction, that portion of the gain that is taxable can be offset by suspended losses. An example would be partial taxable “boot” received in an otherwise 1031 tax-deferred exchange. Here, suspended losses are triggered up to the amount of taxable boot. (For a further discussion of 1031’s, see Chapters 32 to 34-A. Also, see Example 4 below.)

(2) **Installment Sale:** Another example of partial taxable gains is *Installment Sale* reporting under IRC 453. With installment sale, the taxpayer is not receiving all cash on the sale of the property, but instead is taking all or part of the selling price as a note. Taxable income is deferred by spreading out the taxable gain over a period in which the principal payments are collected. Consequently, only a certain percentage of the total gain will be taxable each year. Therefore, not all of the suspended losses will be triggered, IRC 469(g)(3). Suspended losses are triggered only up to the amount of that portion of the recognized (taxable) gain. For a further discussion of installment sales, see Chapter 35.
(3) Other Tax Deferral Provisions: Examples of other non-taxable dispositions that will not trigger suspended losses are tax-free transfers to a corporation (IRC 351) and tax-free transfers to a partnership (IRC 721). The same applies to an involuntary conversion under IRC 1033 (see IRS Pub 544). As with the other tax-deferral provisions, suspended losses are triggered only up to the amount of any gain that is taxable.

**EXAMPLE 4:** You sell a rental property via a 1031 exchange. Of the entire $100,000 realized gain, $80,000 is deferred and the remaining $20,000 is taxable (boot) gain. The $80,000 deferred gain cannot be used as passive income from which to offset unused passive losses. However, the $20,000 taxable (boot) gain can be used to offset unused passive losses.

**STRATEGY 3:** In order to use the suspended losses on a sale, you must segregate each rental property as a separate “activity”. Once you sell the entire property to an unrelated party in a fully taxable disposition, all of the suspended losses on the property can now be used to offset the gain on the sale or disposition. However, in order to use the suspended losses against the gain, the property being disposed of must be the entire interest in a separate activity, IRC 469(g). If it is not, the suspended losses cannot be used to offset the gain.

**NOTE:** Section 469 does not specifically defined the term “activity, despite its importance. Whether an activity is a single activity is based on “facts-and-circumstances” (which means it’s the proverbial gray area).

**TAX TIP:** Demonstrate that each property is a separate activity by keeping a separate accounting for each property’s income and expenses. You have to do this any way for income tax reporting purposes on rental property tax schedules. Computer software programs, such as Quick Books, make this a relatively easy task.

At the very least you certainly should have a separate business account for your rental properties.
STRATEGY 4: ALERT ON UNUSED TAX CREDITS: Unused tax credits (such as rehab and low-income housing credits) may be totally lost upon the full disposition of the property. That is, you cannot offset any such unused credits against the gains on the final sale of the entire property. These valuable credits disappear!

**TIP 1**: Hold off on selling the property and use the tax credits to offset passive income, other than gains on the sale of the entire property. Such passive income would include net taxable rental income and sales of partial interests in rental property, discussed in Appendix B (PAPPB).

**TIP 2**: Properties, qualifying for these tax credits, should show a healthy positive cash flow. *Reason*: These types often show net taxable passive income (with tax liabilities) which can be reduced by the credits.

**TIP 3**: Meet the tests of the relief provision allowing active real estate entrepreneurs to fully deduct rental losses (and fully claim tax credits) without being subject to any passive loss limits regardless of income. This provision includes tax credits. See the next chapter.

**STRATEGY 5**: If the rental properties are showing taxable income, then flunk the tests of the relief provision allowing active real estate professionals to fully deduct rental losses without being subject to PAL limits (per Chapter 26). *Reason*: The net income will not be considered passive income from which you can use to offset passive losses from other properties. Instead, it is considered to be active income which can not be reduced by passive losses.
STRATEGY 6: On the other hand if the rental operations are showing losses, then totally bypass PAL limitations. Do this by following the strategies of the next chapter.

STRATEGY 7: For more planning strategies (namely sales of partial interests in real property) to create passive income in order to reduce passive loss limitations, see Appendix B.

Reference Source (return tab): SAP 11
How To Totally Avoid Passive Loss Limits, Fully Deduct Rental Property Losses...Regardless of the Amount of the Loss, Regardless of the Amount of Your Income!

Reference Source (return tab):  SAP 12

In this chapter we will discuss the following...

A. THE REAL ESTATE TAX SHELTER HAS RETURNED!

B. OVERVIEW OF REQUIREMENTS TO QUALIFY

B-1. THE REQUIREMENTS FURTHER DISCUSSED

B-2. OTHER SUPPORTING STRATEGIES TO DOCUMENT TIME TESTS

C. PRIOR SUSPENDED LOSSES DO NOT QUALIFY UNLESS YOU DO AN AMENDED RETURN

D. MAKING THE PROPER ELECTION TO AGGREGATE ALL OF YOUR FULLY OR PARTIALLY OWNED PROPERTIES AS ONE ACTIVITY TO REDUCE THE AMOUNT OF RECORDKEEPING

D-1. FILE IRS FORM 1065 – NOT SCHEDULE C

E. READ MANAGEMENT PUBLICATIONS FOR MANAGEMENT EDUCATION, PROCEDURES AND HOURS

F. TAX-REDUCTION & AUDIT DOCUMENTATION FORMS TO DOCUMENT HOURS AS A REAL ESTATE PROFESSIONAL

A. THE REAL ESTATE TAX SHELTER HAS RETURNED!
1. There is total relief from passive loss limitations for active real estate entrepreneurs. This relief provision to the passive loss rules was a change that became part of the Revenue Reconciliation Act of 1993 and became effective January 1, 1994. Under this law, active real estate entrepreneurs can fully deduct the rental property losses without limit and thus immediately pocket the tax savings. That is, they can use rental property losses to reduce other types of income such as salaries, commissions, net business income, interest, etc. They can do so regardless of the amount of rental losses (even if over $25,000) and regardless of the amount their adjusted gross income (even if over $150,000), IRC 469(c)(7).

2. Tax Credits Too: The same would also pertain to the rehabilitation credits (ch. 20) and low-income housing credits (ch. 21).

B. OVERVIEW OF REQUIREMENTS TO QUALIFY

Real Estate entrepreneurs can now fully deduct the rental property losses without limit and thus immediately pocket the tax savings, provided they meet the following requirements. These requirements are first listed and then further explained:

1. You must be an “Eligible” Taxpayer.

2. You must be in a “Real Property Trade or Business” (Included here is property management; see requirement 4).
3. You must incur 751 hours a year (or an average of about 14-1/2 hours a week) in one or more of these real property businesses in number 2 above, and spend more than half (51%) of your working hours in one or more of these real property businesses in number 2 above.

4. Included in the above 751 hours, are so many hours (discussed later) that must be incurred in the “Management” of the property.

**ALERT – Necessary hours Must Be Incurred By You, Not a Management Company:** These management hours must be incurred by you or your spouse and not another management entity (such as a corporation) even if you own the entity.

---

**B-1. THE REQUIREMENTS FURTHER DISCUSSED**

**REQUIREMENT 1:** You must be an “eligible” taxpayer.

1. **Those not eligible** - Investors eligible for this relief provisions are taxpayers who are individuals (includes joint tenants and tenant-in-common), general partners in a partnership, active members in an LLC- partnerships and active shareholders in an S-corporations (although an S-corp may have its own limits on deducting losses per ch 5A, B-5).

   C-corporations* qualify if 51% or more of their gross receipts come from real property trades or businesses (defined below) in which the corporation materially participates. (Do not use C or S corporations as a primary entity for real estate).
2. Not eligible - Limited partners, estates, irrevocable non-grantor trusts and C-corporations* who do not meet the above 51% test. See IRC 469(c)(7)(D)(i).

*Note: Properties should not be held in C-corps (or S-corps) anyway

UPDATE: Another loss for IRS on taxing filers who own interests (shares) in LLCs: The Court of Federal Claims agrees with the Tax Court that losses of LLCs aren’t presumptively passive. Owners of LLCs can escape passive loss treatment if they meet one of seven tests to show they materially participated in the business, instead of the limited options that IRS had proposed (Thompson, Ct. of Fed. Claims).

But not owners of limited partnerships, limited liability partnerships, family partnership interests. They are totally subject to massive loss limits. This is why you operate your properties out of an LLC-partnerships

REQUIREMENT 2: You must be in a “real property trade or business.”

1. This includes just about every type of real estate business: Development, construction, acquisition, conversion, rental operation, management, leasing and real estate brokerage*, IRC 469(c)(7), Proposed. Reg. 1.469-9(b)(4). Included are builders, developers, “rehabbers”, rental property owners, landlords, property managers, leasing agents, real estate brokers, real estate sales agents (see next).

2. Other real estate professionals – Real estate agents - While real estate brokers definitely qualify, there may be some doubt about real estate sales agents. I and others say they should qualify because the state rules for real estate “brokerage” incorporate both brokers and sales agents. As for brokers and sales agents being the same for tax purposes, there are several tax court cases to support this - Kersey, 66 TCM 1863; Rice, 38 TCM 990, Grant, CA-4 affg 64-2 USTC 9586, 333 F2d; Tippins, Jr., 24 TCM 521; Wright, 49 TCM 906. Both are generally licensed under the same state law. There is the future possibility of
a *single* real estate license (brokers & sales agents). Therefore, real estate sales agents should qualify.

3. **Other real estate related professionals** - Another real estate business not specifically mentioned is “appraising”. Appraising should qualify because most states incorporate appraising as part of real estate brokerage. (See *Yeager*, 18 TCM 192). Then there are real estate attorneys, real estate auctioneers, real estate lenders, mortgage brokers and mortgage bankers. If they involved in the type of real estate businesses described in number 1 above, they too may qualify.

**GOOD NEWS!** Real estate sales agents can claim a special tax break on their rental losses. Their rental real estate losses are exempt from the passive loss rules if they spend more than one-half of their time and at least 750 hours per year materially involved in real estate, the Tax Court says. This is the identical rule that applies to landlords, developers and real estate brokers. The Service said that sales agents were not covered, but the Tax Court disagreed (Agarwal, TC Summ. Op. 2009-29). In this case, the sales agent who was audited was not licensed as a real estate broker.

**REQUIREMENT 3:** You must incur at least 751 hours a year (or an average of about 14-1/2 hours a week) in one or more of these real property businesses in number 2 above, and spend more than half (51%) of your working hours in one or more of these real property businesses.

1. **The 751 hours covers all aspects of real estate investing** - Including finding properties; negotiating, financing, acquiring, rehabbing, managing, operating, converting, selling, exchanging properties. Thus, incurring 751 hours a year (or about 14/12 hours a week) should not be that difficult.

2. **The 51% test can be met easier than you think even with another job** - More of the difficulty will come with the 51% test. If you have a full time job or business that is not in one of the above real estate businesses, then this
requirement may be difficult to meet. But some tax experts believe that just by
documenting the 751 hours per year 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 your AGI is over $150,000. But even if you are
concerned that you should put in more hours than your job, there is this:

(1) **Not just hours.** It’s not how many hours you are *at* your job, but the actual
“personal services” [IRC 469(c)(7)] you actually perform at the job; again, not
the time you are at the job, which leads to number 2.

(2) **40 hours is not 40 hours/downtime.** So a 40 hour a week job is not 40
hours of actual personal services. Allow for “down time” such as 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 for bargain buys in newspaper ads or researching on the
internet while you are in the lunch or break room).

(3) **Outside office/easy boss.** If you are frequently outside of the office, or
have a boss that does not really care, 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. (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).

(4) **Travel time.** There is also travel time between home and the job, 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 or the internet for bargain buys).

(5) **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 but often get more. Another one of my students was laid off for almost half the year. (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)

(6) **Example**: When all of the above is taken into account, you really may only be working actual hours at your regular job let’s say 25 hours a week. This would mean you would have to incur 26 hours a week in real estate which is very possible when you consider that real estate education (such as home-study courses, seminars and boot camps) also counts as part of these hours.

Use the Goldmine forms to document these real estate business hours, Weekly Summary of Real Property Business Activities (FMOPSBUS) and Weekly Summary of Landlord-Management Activities (FMOPSMGT) on disk, also at the end of the chapter.

(7) **Keep your own time records at your job documenting the 26 hours (or whatever)**. Don’t worry! These are your own personal records, not for your boss.

**SPOUSE’S HOURS CAN HELP**: One spouse meeting these time tests can still allow an inactive owner's 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.

(8) **Audit proof your return.** File extensions. Also, file as a partnership where you report your rental property losses on IRS Form 1065, which at the present time, hardly gets audited.

*Reason*: 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 you have every right to legally protect your return against IRS attacks. *The IRS Restructuring and Reform Act of 1998*. For audit proofing strategies see the next chapter, 26-A.

(9) **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 wealth building. 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 that was discussed in Chapter 1. You will NOT get all of this at some J.O.B. > “Just-Over-Broke”!

3. **Alert on limitation for employees of a real estate business.** For the purpose of meeting these time tests, the services of an employee in the above real estate businesses (requirement 2) are not eligible, unless the employee is more than a 5% owner of the company, IRC 469(c)(7)(D)(ii); *Pungot*, TC Memo 2000-60.
This means to qualify, you have to own 6% or more of a company that performs one or more of these qualifying real estate businesses.

**EXAMPLE:** You are an employee of *Diversified Property Associates* (DPA), LLC, a company that does real estate development, investing and management (which are all qualifying real property businesses). Assume you have no ownership in this company and you also do your own real estate investing (outside of the company). In meeting these time tests), **you cannot count any of the hours you spend for DPA, because you do not own 6% or more of the company.** Thus, if you work 35 hours a week for this company, that’s 35 hours that you cannot use to meet these two tests. This is so even though you may be performing these real estate business activities for DPA, LLC.

**STRATEGY:** Acquire a 6% or more interest in the company. If not, join a company where you can do this, or even better form your own company. Remember this, *Non W-2 Entrepreneurs make more money and also save more taxes.*

**REQUIREMENT 4:** Included in the above 751 hours, are so many hours (discussed below) that must be incurred in the “Management” of the property. Included in the 751 hours are so much time a year managing & operating the property. This is known as the “material participation” (MP) requirement which means meeting any one of the following three alternate tests in managing and operating the property:

**MP Test 1:** Incur **501 management hours** a year (or an average of about 10 management hours a week), Reg. 1.469-5T(a)(1); or

**MP Test 2:** Incur **101 management hours** a year (or an average of about 2 management hours a week) provided that no one else (including co-owners, employees and property managers) are participating with more hours than the investor, Reg. 1.469-5T(a)(3). (This one could allow the investor to satisfy this
requirement with less than 500 hours a year: see also Hegarty, TC Summ. Op 2009-153); or

**MP Test 3:** Incur **substantially all of the participation** in managing the property, Reg. 1.469-5T(a)(2). This probably would mean incurring 71% or more of the business hours managing the property. (This one could allow the investor to satisfy this requirement with less than 101 hours a year). **ALERT:** Here you should still keep records of management hours incurred using Goldmine form, FMOPSMGT *(Landlord-Management Activities)* at the end of this chapter and on the *Renaissance* Goldmine forms disk..

Pertaining to the above three alternate MP tests, there are the following pointers:

(1) **Less time with MP tests 2 and 3** - Tests 2 and 3 above require less hours and will work best for properties with less help from employees, managers or other co-owners.

(2) **With other active owners** – You may own the property with other active co-owners either as tenants-in-common in a joint venture, partners in a general partnership or managing members in an LLC-partnership. Here, you may have to comply with test 1 and incur at least 10 hours a week in managing the property. Alternatively, it appears you can meet the lesser hour requirements of test 2 if each of the co-owners spends the *same* amount of time at 101 hours a year or 2 hours per week managing the property. In another words, to comply with test 2, you do **not** want your co-owners to be spending *more* hours than you in managing the property.

(3) **Your spouse’s time counts** - Your spouse’s time counts for meeting the above tests even if separate returns are filed or the other spouse does not have an ownership interest in the property, Proposed Reg. 1.469-9(c)(3). For example, husband & wife each devote an average of one hour a week to operate their properties. Both of their combined hours equals 2 hours a week or *over*
101 hours a year. They therefore could qualify for material participating test 2, 101 hours.

(4) Document with Goldmine form - To document these real estate management hours, use Goldmine form, FMOPSMGT, (Landlord-Management Activities) at the end of this chapter and on the Renaissance Goldmine forms disk. Each active co-owner and each active spouse, wanting to meet these requirements, should use this form.

(5) Management time also counts toward 751 hours -- The same time you document for management time for meeting this “material participation” requirement (Req. 4), you also count for meeting 751 hour business requirement (Req. 3). This is because the real estate business activities of requirement 3 include the management activities of this requirement 4.

(7) Make an “Aggregate Election - These time tests will be made much easier if the investor properly elects to aggregate all of their properties (this election is covered later in this chapter).

(8) What is property management for the purpose of meeting this test. The owner must document that they are directly involved with the day-today management and operations of the property. According to the regulations, the following (financial) activities are not management activities - studying and reviewing financial statements, preparing or compiling summaries or analyses of the finances of the activity for the individual’s own use and monitoring the finances or operations of the activity in a nonmanagerial* capacity. Reg. 1.469-5T(f)(2)(ii). (*Emphasis added). This regulation is somewhat unclear when it uses the words “nonmanagerial” capacity. In other words, if the above financial activities are performed in a “managerial” capacity, are they then considered to be qualifying “management” activities under this requirement? “Property management”, as we know the terminology, is not just “tenant” or “landlord” management (selecting or evicting tenants). It involves a whole broad spectrum of financial activities (including the above) with the purpose of operating the
property efficiently, increasing property cash flow. Therefore, it certainly could be argued that such financial activities are part of property management. This is especially so if the property owner is an active entrepreneur as opposed to a passive investor, such as a limited or silent partner.

**What-To-Do:** Again use both Goldmine forms at the end of this chapter (part F), or in Forms Appendix of the SAP’s, to document the necessary management hours:

*Weekly Summary of Real Property Business Activities (FMOPSBUS)* which contains activities in the “Financial Administration \ Operations of Property”. (Form 10 in Forms Appendix of the SAP’s)

*Weekly Summary of Landlord-Management Activities (FMOPSMGT)* which contains over 30 activities that are clearly day-to-day managerial activities. (Form 11 in Forms Appendix of the SAP’s)

Accordingly these activities should clearly qualify under Regulation 1.469-5T(f)(2)(ii). So this form is the more important one to use to document management hours.

### B-2 OTHER STRATEGIES TO SUPPORT DOCUMENTING TIME TESTS (751 HOURS/51% TESTS)

(1) Keep calendar entries (such as a Daytimer or Palm Pilot) in addition to the above Goldmine forms (*D’Avanzo*, Ct. of Fed. Claims). For example, you should have calendar entries documenting appointments with sellers, buyers, lenders, mortgage brokers, real estate agents, appraisers, attorneys, accountants,
bird dogs, contractors, title companies, property managers, fellow investors, mentor, coach, consultant, management seminars, etc.

(2) **Keep other forms of proof to further document these hours.** Examples - Notes taken during a negotiation, loan applications, appraisal reports, contractor bids, Realtor listing agreements, sales and purchase agreements, etc.

(3) **You or your spouse (or both), list your occupation as “Property Manager” at the bottom of 2 of your 1040.** This could be very effective.

(4) **Have a provision in your LLC operating agreement, that as a managing member you are required to meet the necessary time tests.**

An example of such a provision is: *Members are to incur the necessary time and hours to actively and materially participate in Company Property management and Company business operations so they can be active and not subject to passive loss limitations in accordance with Internal Revenue Code Section 469(c)(7); Regulation 1.469-9; Regulation 1.469-5T; any other applicable tax law provisions; and any successor provisions issued thereunder.*

(5) **Have a complete business plan about your real estate investing.** Not only does this make great business sense, but a business plan helps to demonstrate your *business intent* for profit and corroborates the above documentation.

(6) **Obtain your real estate license so you can better demonstrate that you are an active real estate professional.** This is not required but could help. Real estate schools are listed in the yellow pages as “Real Estate Schools”. (In the Philadelphia area, I highly recommend *Schlicher-Kratz Institute of Real Estate*, (215) 855-1265)

(7) **Have your own real estate web site which includes marketing how your company is efficient, competent and ethical in managing its properties and residents.** Every bit of proof helps. Today you can do much of your real estate investing and managing on the internet with one or more web sites. For a free
customizable web site go to goldminewebsites.com. Yes, as a Goldmine student you are entitled to it.

(8) On your voice mail have your (or spouse’s) voice mention about the availability of your rental units. Again, every bit of proof helps.

(9) If you rehab the property take photos of all the work done on the property from beginning to end, putting the date and year of each photo. Keep copies of work orders, contracts and other related documents.

(10) Document auto & travel expenses. Reason: The above activities may require at least some travel time & expense. Not only will this give you more deductions, but will also better support your time in these business and management activities.

C. PRIOR SUSPENDED LOSSES DO NOT QUALIFY UNLESS YOU DO AN AMENDED RETURN

Unfortunately, meeting the above requirements will not enable the investor to currently deduct prior suspended losses against non-passive income. These suspended losses will be allowed against passive income. Generally such passive income, from which suspended losses can be used, will be generated when the property is sold in a fully taxable disposition to an unrelated party as per Chapter 25-A. However, you may be able to file amended returns if you have the supporting documentation.
TAX ALERT: ON USING THIS PROVISION IF THE RENTAL PROPERTIES ARE SHOWING TAXABLE INCOME - This provision is ideal for rental properties showing net losses (that will no longer be passive). *Reason:* Under this provision the net income of these “active” real estate businesses would *not* be considered passive income from which you can use to offset passive losses from other properties. Instead, it is considered to be active income which can *not* be reduced by unused passive losses.

**EXAMPLE:** You have unused suspended passive losses of $20,000 from prior years. In the current year your rental properties are showing net rental income of $30,000. If you meet the requirements of this provision, the $30,000 is active income and can *not* be reduced by the unused passive losses of $20,000. On the other hand if you do not meet these requirements, the $30,000 would be passive income. You then can then reduce the $30,000 by the $20,000 passive losses. See the reverse strategy, next.

**REVERSE STRATEGY:** Do *not* use this provision, if passive income is needed to offset suspended losses. To do this you must flunk any one of the requirements: (1) Eligible Taxpayer, (2) Real Property Business, (3) 751 Hours (4) Material Participation. Do this at least for the year you need to offset the passive losses.

On the other hand, if the rental operations are showing losses, then use this provision.

**D. MAKING THE PROPER ELECTION TO AGGREGATE ALL OF YOUR FULLY OR PARTIALLY OWNED PROPERTIES AS ONE ACTIVITY TO REDUCE THE AMOUNT OF RECORDKEEPING**
If the investor owns more than one interest in real estate, the investor should make an election* to aggregate all of their fully or partially owned properties as one activity. If the investor does not make this election, each interest in a property (full or partial) will be considered a separate activity. This means that requirement 4, the material participation (MP) tests (501 hrs., 101 hrs., etc.) must be met separately for each property. This would call for burdensome recordkeeping (to say the least).

**What To Do** – Make the election to aggregate all of the investor’s properties as one activity is made by filing a statement with the investor’s income tax return, to be attached to form 1040 and also right behind the property rental schedule, if the property files a separate tax return (apart from 1040) such as form 1065. (For an example, see below.) The election is to be made in accordance with IRC 469(c)(7)(A)(ii) and Prop. Reg. 1. 469-9(g). It is binding for all future years. However, if there is a material change in the investor’s facts and circumstances*, the investor may revoke the election, Reg. 1. 469-9(g). (*Unfortunately, there is no further guidance as to what is a “material change in facts and circumstances.”)

**ALERT**: Do not group properties with a limited partnership. If one or more of the properties are owned by a limited partnership, and other rental properties (not in a limited partnership) are aggregated with this interest, then all of the properties (including those not in a limited partnership) will be treated as a limited partnership interest for purposes of meeting requirement 4, material participation. This means that none of the properties will qualify for the unlimited write-off of rental losses, as per this provision. Prop. Reg. 1.469-9(f)(1). So don’t do it!

**STRATEGY**: Avoid limited partnerships, where real estate activities will be showing tax losses. You want to anyway as per Chapter 7.
ELECTION TO AGGREGATE ALL RENTAL PROPERTY INTERESTS
UNDER SECTION 469(C)(7)(A)

Tax year: ________20_______. Taxpayer name:_________________________

Taxpayer identification number: ____________________________________

In accordance with Regulation 1.469-9(g)(3), the above taxpayer hereby states that they are a qualifying taxpayer for the above tax year and that they elect to treat all of their interests in rental real estate as a single real estate activity.

D-1. FILE IRS FORM 1065 – NOT SCHEDULE C

Even if you are an active real estate entrepreneur under this provision and are not subject to the passive loss limitations, you still do not have to file the highly audited Schedule C for real estate to be a business. You should file as a partnership on IRS Form 1065. Partnership returns are generally audited less than Schedule E’s or C’s. An LLC as a partnership is even better for limited liability. (For using LLC-partnerships see Chapter 5.)

NOT A DEALER: Documenting these real estate business\management activities does not make you a dealer. Reason: These activities has to do with property operations. Dealer activities has to do with selling. See Ch 42 for avoiding being a dealer.
E. READ MANAGEMENT PUBLICATIONS FOR
MANAGEMENT EDUCATION, PROCEDURES AND
HOURS

Not only does highly effective property management increase cash flow and
reduce tenant/maintenance problems, it also gives you the foundation to help
document sufficient management hours by reading them and using their
procedures. Some of the best publications are:

1. Mr. Landlord - A superb monthly newsletter on the creative
management\marketing of residential rental properties. See
1-800-950-2250

2. Down To Earth Landlording by Don Beck To order this excellent
publication, try www.donaldpbeck.com or call 1-215- 542-9804. Don has also
has an approved “plain-language” lease.

3. How To Manage Residential Property for Maximum Cash Flow and Resale
Value by John T. Reed. Also an excellent publication. Call 1-925-820-6292.

4. Institute of Real Estate Management (IREM). IREM has a variety of other
excellent publications on property management for commercial and residential
real estate. Call 1-800-837-0706 or 1-312-661-1953.

18
Note: The attached forms are for backup document purposes only. Do NOT attach them to your tax returns

F. TAX-REDUCTION & AUDIT DOCUMENTATION
FORMS TO DOCUMENT HOURS AS A REAL ESTATE PROFESSONAL

[Note: These forms are for back-up documentation. Do NOT attach them to your tax return, instead use the audit proofing statement in Chapter 26-A.]

FORM 10: Weekly Summary of Real Property Business Activities

FORM 11: Weekly Summary of Landlord-Management Activities

FORM 12: Attendance At Real Estate Education Event

FORM 10: Weekly Summary of Real Property Business Activities

[Activities Other Than “Tenant” Management Material Participation]

Property owner name__________________________________ Period ending_____/_____/______

<table>
<thead>
<tr>
<th>R.E. BUSINESS ACTIVITY FOR INVESTMENT PROPERTY</th>
<th>Hrs.</th>
<th>Miles</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. Acquisition of Property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Check &amp; review sources for finding</td>
<td></td>
<td></td>
</tr>
<tr>
<td>investment properties..................................</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Develop a list of bird dogs as sources of</td>
<td></td>
<td></td>
</tr>
<tr>
<td>good buys and motivated sellers...................</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Meet with bird dogs as sources of good buys</td>
<td></td>
<td></td>
</tr>
<tr>
<td>and motivated sellers...............................</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Do a market\location analysis including</td>
<td></td>
<td></td>
</tr>
<tr>
<td>emerging or reemerging locations..................</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

19
5. Checkout specific neighborhoods performing a neighborhood analysis

6. Physically go out look for investment properties

7. Contact prospective property owners

8. Do a preliminary quantitative analysis on properties (such as the cap rate)

9. Do a preliminary “drive-by” property inspection

10. Make & negotiate purchase offers on property

11. Verify the income, expenses, vacancies on the property’s operating statement

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

13. Do a thorough physical property inspection analysis of property

14. Obtain Estoppel Statements from the seller and tenants

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

16. Make a final offer

17. Prepare contract for purchase of property

18. Review seller’s contract for purchase of their property

19. Check out sources of financing for acquiring property

20. Review your credit report; repair or correct accordingly

21. Prepare a Credibility & Profile Package outlining your ability and credibility

22. Meet and develop rapport with lending sources

23. Prepare a Loan Package for a property acquisition

24. Arrange for financing for acquiring property

25. Negotiate the seller to hold financing

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

27. Do a pre-closing inspection of the property

28. Attend the closing of the purchase of the property

29. Take care of any post-closing matters

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

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

B. Financial Administration\Operation of Property:

32. Select\meet\change CPA for the property financial & tax affairs

33. Select\meet\change attorney for the property legal affairs

34. Select\meet\change a bank which handles the property’s accounts

35. Select a qualified bookkeeper

36. Select a suitable bookkeeping\tenant-tracking computer-based system

37. Do or supervise the bookkeeping, accounting and tax work for the properties

38. Prepare and revise operating statements, budgets, cost control, tax planning, etc...

39. Review & update the insurance needs on the property

40. Review real estate tax assessments for possibility of an appeal to lower taxes

41. Establish a web site for you as a real estate investor and your properties

42. Approve hiring & firing of office personnel - employees & independent contractors

43. Make the appropriate recommendations for improvement of above on periodic basis

44. Management participation activities (see attached separate Form, FMOPSMGT)
C. Condo Conversion Analysis:
45. Review if property is adaptable for a cost-effective condo conversion………………
46. Is there a current resale market demand for condos in property location………………
47. Review state or local guidelines on regulating condo conversion…………………………
48. Select legal specialists to do condo conversion documents…………………………
49. Select marketing specialists to sells condos………………………………………………
50. Review if condos will be kept for rentals; or sold\exchanged…………………………
51. Review tax impact and planning of condo sales (refer to Albert Aiello’s new commercial tax course, Astronomical Tax Savings With Commercial Property which has three chapters just on condo conversions)…………………………………………………………

D. Sale\Exchange of Property:
52. Do a income tax analysis before selling the property (See Section 31 of Goldmine)…
53. Review seller tax reduction strategies (eg: 1031 exchange, PAT, installment sale) (See Section 31 of the Goldmine)………………………………………………………………………………………..
54. Prepare the property for sale\exchange (improvements, raise rents, tell tenants, etc.).
55. Evaluate marketing techniques to sell or exchange the property…………………………
56. Interview and select a RE agent to list the property with……………………………………
57. Frequently follow-up with the listing agent…………………………………………………………
58. Review and negotiate offers on the property for sale…………………………………………………..
59. Arrange for financing for selling the property…………………………………………………..
60. Review selling the property with creative financing (eg: lease-option; seller fin.)…..
61. Prepare for closing of the property sale, such as arranging inspections, certs, etc……..
62. Attend pre-closing inspection of the property…………………………………………………..
63. Attend the closing of the sale of the property…………………………………………………..
64. Take care of any post-closing matters………………………………………………………….

E. Real Estate Educational Events
65. Attendance at real estate investor association monthly meetings……………………………..
66. Attendance at real estate education seminars, conferences, boot camps and cruises* (*document hours for these activities by using separate form, Attendance At Real Estate Education Event on this disk as FMOPSED)………………………………………..
67. Reading or listening to (tapes) related real estate education……………………………..

F. Other Related Bus. Activities:
68. Other

(for management activities (see attached separate Form FMOPSMGT)

TOTAL HOURS\MILES…………………………………………………………………………………..

AUTHORITATIVE CITE: In doing the above it is my intention to comply with the recordkeeping requirements of Regulation 1.469-(c)7)(C) for time incurred in a qualifying real estate business as per this code section.

________________________________
(signature of rental property owner)                     Date
FORM 11: Weekly Summary of Landlord-Management Activities
[IRS Regulation 1.469-5T(f)(4)]

For the week ending______/__________/_____________

NAME OF PROPERTY OWNER__________________________________________________________

<table>
<thead>
<tr>
<th>MANAGEMENT ACTIVITY</th>
<th>Hrs.</th>
<th>Auto Hrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Analyze the rental market, including vacancies</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2. Analyze type of tenant (quality-wise) the property will attract (within fair-housing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Analyze if the current market supports raising rents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4. Analyze if cosmetic improvements can be made for higher rents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Analyze if structural improvements can be made for higher rents (e.g., redo floor plans)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6. Analyze if rents can be increased by catering to certain types (within fair-housing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Check for any special tenant programs (such as Section 8 or assisted housing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>8. Market the property for rental</td>
<td></td>
<td></td>
</tr>
<tr>
<td>9. Show the property for rental</td>
<td></td>
<td></td>
</tr>
<tr>
<td>10. Decide the rental terms for tenant leases</td>
<td></td>
<td></td>
</tr>
<tr>
<td>11. Take, accept and process tenant applications</td>
<td></td>
<td></td>
</tr>
<tr>
<td>12. Thoroughly screen tenants by interviewing them</td>
<td></td>
<td></td>
</tr>
<tr>
<td>13. Thoroughly screen tenants by checking prior landlord and job references</td>
<td></td>
<td></td>
</tr>
<tr>
<td>14. Thoroughly screen tenants by checking out where they live talking to neighbors</td>
<td></td>
<td></td>
</tr>
<tr>
<td>15 Approve tenants in accord with fair housing rules</td>
<td></td>
<td></td>
</tr>
<tr>
<td>16. Disapprove prospective tenants in accord with fair housing rules</td>
<td></td>
<td></td>
</tr>
<tr>
<td>17. Prepare the leases</td>
<td></td>
<td></td>
</tr>
<tr>
<td>18. Review leases with tenants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>19. Move-in processing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20. Move-out processing</td>
<td></td>
<td></td>
</tr>
<tr>
<td>21. Clean &amp; prepare units for rental</td>
<td></td>
<td></td>
</tr>
<tr>
<td>22. Collect rents</td>
<td></td>
<td></td>
</tr>
<tr>
<td>23. Handle any tenant evictions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>24. Handle any other tenant problems</td>
<td></td>
<td></td>
</tr>
<tr>
<td>25. Initiate new rental &amp; tenant selection policies (in accord with fair housing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>26. Review to reduce turnover costs via vacancies with better management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>27. Create management efficiency by separating/transferring utilities to tenants</td>
<td></td>
<td></td>
</tr>
<tr>
<td>28. Create management efficiency by looking to use unutilized space (e.g., basement, attic)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>29. Review additional sources of income from storage facilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30. Review additional sources of income from laundry facilities</td>
<td></td>
<td></td>
</tr>
<tr>
<td>31. Review additional sources of income from vending machines</td>
<td></td>
<td></td>
</tr>
<tr>
<td>32. Review additional sources of income from parking</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33. Review additional sources of income from optional upgrades (2nd TV, computer)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>34. Review additional sources of income from other sources (e.g., maid service)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
35. Do or discuss renovations for property expansion.................................
36. Hire a management company or resident manager.................................
37. Fire management company or resident manager....................................
38. Hire & recruit maintenance personnel...................................................
39. Fire maintenance personnel....................................................................
40. Supervise the resident manager, maintenance personnel & other mgmt.
    personnel.............................
41. Approve all capital or repair expenditures for management
    efficiency............................
42. Decide who makes, or is to be responsible for repairs, maintenance &
    improve......................
43. Initiate\review strategies for property security, safety &
    sanitation..........................
44. Create management efficiency with a program of preventative maintenance (PM)
45. Review any property maintenance and service contracts (heater, exter., etc.)
46. Set up purchasing procedures for maintenance supplies &
    materials............................
47. Shop & purchase for maintenance supplies & materials...........................
48. Review the reserve for the replacement of improvements, appliances, etc........
49. Personally inspect the property for maintenance & management
    efficiency..................
50. Personally talk to the tenants for maintenance & management
    improvement..................
51. Review the insurance needs of the property for management efficiency........
52. Reduce operating expenses (via APOD) without loss of property quality or safety
53. Review & update overall property management & operational
    procedures........................
54. Review property management/tenant tracking software
    programs..............................
55. Prepare and update the resident’s management newsletter or handbook........
56. Read MR. Landlord and other property management publications............... 
57. Attendance at management seminars, conferences, boot camps and cruises* (*document
    hours for these activities by using separate form, Attendance At
    Real Estate Education Event on this disk as FMOPSED).......................... 
58. Other

TOTAL HOURS\MILES...................................................................................... 

In doing the above it is my intention to comply with the recordkeeping
requirements of Regulation 1.469-5T(f)(4) and IRS Publication 925 for the
management and operation of my rental activity.

_________________________________________  ________________________________
(signature of rental property owner)                Date

COPYRIGHT 2010 - ISU- ALL RIGHTS RESERVED (\RETA\FMOPSMGT)
INVESTOR TIP: For purposes of better marketing, use “resident” not “tenant” - The above forms use “tenant” for easier recognition and the easier use of the form to fulfill its purpose. However, landlording genius, Jeffrey Taylor, (“Mr. Landlord”) gives great advice - call them “residents”, not “tenants”. Jeffrey has superb management and cash flow publications. Check out his web site, [www.mrlandlord.com](http://www.mrlandlord.com).

### FORM 12: Attendance At Real Estate Education Event

1. Event title: __________________________________________________________

2. Event dates and year: ________________________________________________

3. Event city/state: _______________________________________________________

4. Event hotel or facility: ________________________________________________

5. Event leader: __________________________________________________________

6. Event Instructor(s): ____________________________________________________

7. Event tuition: $______________.

8. Actual sessions attended: See below.

#### Actual Sessions Attended

**Day 1: Date _______________ 20____**

<table>
<thead>
<tr>
<th>Session</th>
<th>Topics Covered</th>
<th>Instructor(s)</th>
<th>Hrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Day 2: Date _______________ 20____**

<table>
<thead>
<tr>
<th>Session</th>
<th>Topics Covered</th>
<th>Instructor(s)</th>
<th>Hrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time</td>
<td>Topics Covered</td>
<td>Instructor(s)</td>
<td>Hrs.</td>
</tr>
<tr>
<td>-------</td>
<td>----------------</td>
<td>---------------</td>
<td>------</td>
</tr>
<tr>
<td>1st AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Day 3: Date** __________ 20__

<table>
<thead>
<tr>
<th>Session</th>
<th>Topics Covered</th>
<th>Instructor(s)</th>
<th>Hrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Day 4: Date** __________ 20__

<table>
<thead>
<tr>
<th>Session</th>
<th>Topics Covered</th>
<th>Instructor(s)</th>
<th>Hrs.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd AM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1st PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2nd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3rd PM</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**AUTHORITATIVE CITE:** I attest that the above hours are for directly related real estate continuing business education under IRC 162, Regulation 1.162-5 and Regulation 1.212-1(l) and in doing the above it is my intention to comply with the recordkeeping requirements of Regulation 1.469-(c)7)(C) for time incurred in a qualifying real estate business as per this code section.

__________________________________________
(signature of rental property owner)         Date
**Full Tax Deduction: RE Investors > Beware of wrong advice from speakers and tax advisors! You can deduct these real estate courses as well as conventions, seminars, boot camps, cruises.**

**TAX LAW SUPPORT:** Background & Misunderstanding - According to Internal Revenue Code Section 274(h)(7), “No deduction shall be allowed under section 212 for expenses allocable to a convention, seminar or similar meeting.” This very short clause has caused many people (including speakers and tax advisors) to misinterpret this as meaning that real estate investors cannot deduct expenses for a convention, seminar, similar meeting or even home-study courses. But the key wording in the above provision is “Section 212”, which has to do with the production of more passive income, such as that from stocks or bonds. This is opposed to Internal Revenue Code Section 162 which has to do with a trade or business, such as real estate. Under IRC 162, such expenses are fully deductible. The question is this -- Is the ownership of real estate an **investment** (Section 212), or is it a **business** (Section 162)? There is substantial authority to support that the ownership of real estate (even one property) is a **business** under IRC 162. Accordingly, being in the real estate **business**, you can deduct these home-study courses, conventions and seminars under IRC 162 and IRS Regulation 1.162-5. (For tax law authority supporting real estate as a “business” vs. “investment”, see Chapter 3.) Plus, for **tax courses** (giving tax advice) there is further support in that expenses paid for tax advice are deductible as per IRS Regulation 1.212-1(l).

**HOW AND WHERE TO FULLY DEDUCT:** For all of the following IRS forms*, you attach a separate schedule - “other deductions” on which you insert as an added line item - “**Directly related business education per IRC 162**”. [*These IRS forms include the following: Rental property Schedule E; The preferred partnership return-form 1065; Or Corporation business return-form 1120 for a C-corporation or 1120S for an S-corporation, but avoid corporations for primary real estate ownership].

Reference Source: **SAP 12**

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**
Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Audit-Proofing Strategies
To Totally Avoid Passive Loss Limits, Fully Deduct Rental Property Losses...Regardless of the Amount of the Loss, Regardless of the Amount of Your Income!

Reference Source (return tab): SAP 12

In this chapter we cover the following...

A. AUDIT RISK

B. AUDIT-PROOFING STRATEGIES

C. FORM: AUDIT PROOFING STATEMENT -- ELIGIBILITY TO FULLY DEDUCT RENTAL PROPERTY LOSSES (Blank and Filled-In Formats)

A. AUDIT RISK

This is still a fairly complex provision, which IRS agents do not yet fully understand. Of course, the tax savings from these rental property losses is another good reason to attempt to disallow this provision. Therefore, fully deducting rental losses, regardless of the amount of losses (esp. larger than $25,000) and regardless of the amount AGI, could be an audit red flag. Added to this potential dilemma is that many tax practitioners either do not know about this provision or do not fully understand it. Therefore, being represented on an audit by one of these ill-educated tax advisors only worsens the situation.

B. AUDIT-PROOFING STRATEGIES
(1) Avoid Schedule C or E, File a partnership return, form 1065 (with an LLC for protection). See Chapter 5 for a further discussion of LLC-partnerships. If you do this, you should still adhere to the following planning recommendations.

(2) If you use Schedule E (which you should not), do not take a deduction for any management fees on line 11. Deduct such fees on line 10, Legal and other professional fees. On the partnership (1065) rental real estate schedule (form 8825) there is no line for management fees, so use line 10, Legal and other professional fees. (This is another reason you should file as a partnership, 1065 as it is more of a user-friendly form for claiming deductions). The reason for this - if you are deducting management fees, this shows you are using a separate management company incurring management hours instead of you. See Chapter 5-B as to why you should not be using your own management company.

(3) You or your spouse (or both), list your occupation as “Property Manager” at the bottom of 2 of your 1040. Again, this could be effective.

(4) On your rental property IRS schedule (such as form 1065-8825), make this notation, “See Attached Statement Of Eligibility To Fully Deduct Rental Losses.” Then attach the audit proofing statement below behind your rental property schedule.

C. FORM: AUDIT PROOFING STATEMENT -- ELIGIBILITY TO FULLY DEDUCT RENTAL PROPERTY LOSSES (Blank and Filled-In Formats)

STATEMENT OF ELIGIBILITY TO FULLY DEDUCT RENTAL PROPERTY LOSSES AS AN ACTIVE REAL ESTATE PROFESSIONAL

Tax year: ________. Taxpayer name: ___________________________________________
Taxpayer identification number: _______________________________________________
Statement: "The deductibility of my rental property losses comes under a change that become part of the Revenue Reconciliation Act of 1993 and became effective January 1, 1994. Under this law, active real estate professionals can deduct the above losses regardless of the amount of rental losses (even if over $25,000) and regardless of the amount their adjusted gross income, Internal Revenue Code Section 469(c)(7). I meet all of the five requirements of this provision, which are:

(1) I am an ‘‘eligible’’ taxpayer as per IRC 469(c)(7)(D)(i); 

(2) I am in a qualifying ‘‘real property trade or business’’ as per IRC 469(c)(7), Regulation 1.469-9(b)(4); 

(3) I spend more than half of my personal-services time in one or more of the above real property businesses in number 2 above as per IRC 469(c)(7)(B); spend at least 751 hours a year in one or more of the above real property businesses in number 2 above as per IRC 469(c)(7)(B); and

(4) I ‘‘materially participate’’ in the management operations of the property by incurring the required amount of hours in the management of the property as per Regulations 1.469-4(d) and 1.469-5T.

RECORDKEEPING: I document the required hours by keeping detailed daily and weekly time records as per Regulation 1.469-5T(f)(4) and IRS Publication 925. These time reports are readily available upon request.

INTENT FOR PROFIT (Internal Revenue Code Section 183): If a property is not rented at any given time, documented and vigorous attempts are made to quickly rent the property in the way of newspaper ads, ‘‘for rent’’ sign, the internet, listing contracts, flyers, etc. Also, separate business records are kept. During any vacant period the property is not at all used personally by an owner or a related party (per Internal Revenue Code Section 280A). The primary intent is to make a profit from the property as per Internal Revenue Code Section 212 and Regulation 1.212-1 (Expenses for production of income)"

_______________________________  ____________________
Respectively and truthfully submitted  Notary Public

Other recommendations for audit-proofing statements:

(a) Be truthful.
(b) They should be typed neatly and attached right behind the IRS rental property schedule.

(c) Include your name, identification number and the tax year.

(d) Sign the statement and have it notarized. This adds credibility.

A sample filled-in version follows on the next page

STATEMENT OF ELIGIBILITY TO FULLY DEDUCT RENTAL PROPERTY LOSSES AS AN ACTIVE REAL ESTATE PROFESSIONAL

Tax year: 20XX. Taxpayer name: Rhonda Investor

Taxpayer identification number: 999-99-9999

Statement: "The deductibility of my rental property losses comes under a change that become part of the Revenue Reconciliation Act of 1993 and became effective January 1, 1994. Under this law, active real estate professionals can deduct the above losses regardless of the amount of rental property losses (even if over $25,000) and regardless of the amount their adjusted gross income, Internal Revenue Code Section 469(c)(7). I meet all of the five requirements of this provision, which are:

(1) I am an “eligible” taxpayer as per IRC 469(c)(7)(D)(i);

(2) I am in a qualifying “real property trade or business” as per IRC 469(c)(7), Regulation 1.469-9(b)(4);

(3) I spend more than half of my personal-services time in one or more of the above real property businesses in number 2 above as per IRC 469(c)(7)(B); spend at least 751 hours a year in one or more of the above real property businesses in number 2 above as per IRC 469(c)(7)(B); and

(4) I “materially participate” in the management operations of the property by incurring the required amount of hours in the management of the property as per Regulations 1.469-4(d) and 1.469-5T.

RECORDKEEPING: I document the required hours by keeping detailed daily and weekly time records as per Regulation 1.469-5T(f)(4) and IRS Publication 925. These time reports are readily available upon request.

INTENT FOR PROFIT (Internal Revenue Code Section 183): If a property is not rented at any given time, documented and vigorous attempts are made to quickly rent the property in the way of newspaper ads, “for rent” sign, the intermit, listing
contracts, flyers, etc. Also, separate business records are kept. During any vacant period the property is not at all used personally by an owner or a related party (per Internal Revenue Code Section 280A). The primary intent is to make a profit from the property as per Internal Revenue Code Section 212 and Regulation 1.212-1 (Expenses for production of income)”

**Rhonda Investor**  
Respectively and truthfully submitted                                         Notary Public

**JJ Associates**

Reference Source (return tab):  **SAP 12**

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
BANG, BANG, BANG... KILL THAT LOSS! If the IRS misses you the first time, they still have more ammunition to try to destroy your valuable rental property losses. Chapters 25, 25-A, & 26 discussed strategies on how to bypass passive loss limits. This chapter discusses more strategies to counter these other three IRS attacks on rental property losses. In this chapter we will discuss the following...

| A. “HOBBY LOSS” RESTRICTIONS (IRC 183) |
| B-1, STRATEGIES TO BYPASS HOBBY LOSS RESTRICTIONS |

| B. PERSONAL-USE (“VACATION-HOME”) LOSS RESTRICTIONS (IRC 280A) |
| B-1. STRATEGIES TO BYPASS VACATION-HOME LOSS RESTRICTIONS FOR RELATED PARTY TRANSACTIONS |
| B-2 OTHER PLANNING STRATEGIES TO BYPASS THESE LOSS RESTRICTIONS |

| C. SAMPLE “AUDIT-PROOFING STATEMENTS” TO ATTACH TO YOUR RENTAL PROPERTY SCHEDULES FOR A AND B ABOVE |

| D. BUYER “AT-RISK” LIMITATIONS WITH NON-RECOREUSE SELLER FINANCING (IRC 465) |
A. “HOBBY LOSS” RESTRICTIONS (IRC 183)

1. You can claim losses beyond 2 years. IRC 183(d) states that a business is presumed to be engaged in for profit if it shows a profit for any 3 or more years in a period of 5 consecutive years. IRS agents often interpret this law to mean that if a business (including rental property) shows a loss more than 2 years in a row, then the business is a non-deductible “hobby”. If this were strictly true, then you would not be allowed to deduct a loss in the third year as well as later years. A real tax disaster in the making, unless we know the law and plan.

2. IRS abuse, but they can be beat! IRS agents will use (and abuse) the hobby loss provision and frequently try to disallow legitimate losses on rental properties (and other businesses). This happened to CPA, Ron Noll, on an IRS audit of a rental property. The IRS agent said it was a hobby loss because the taxpayer did not list the property with a Realtor. While this would have been a help, it is still not the deciding factor. The taxpayer had other proof of intent-for-profit such as for-rent ads, plus it was actually rented for a period of time before eventually being sold at a profit. Ron had to take it to appeals, but won. Sometimes the IRS really carries this issue way too far. This is what happened to Al Brindisi, CPA, when he represented someone who started a trucking business, purchased a tractor-trailer, which he depreciated and took other related deductions. The IRS argued that the truck was a hobby! Who in the world would buy a tractor-trailer for a hobby? Al did win in appeals. However, these scenarios show how lack of tax-law-knowledge and poor planning can be dangerous to your financial health.

3. Overall strategy - know the law as follows: The 3 out of 5 year rule is not a mechanical test but only a guideline as Reg. 183-1(a) states: "No inference that the activity isn't engaged in for profit is to arise from the fact that the 3-in-5
year test is not met." As an alternative to the 3 out-of 5 year test, other facts and circumstances may be taken into account in determining whether an activity is engaged in for profit. These factors are: The manner in which the taxpayer conducts the activity, the expertise of the taxpayer or his advisers, the time and effort taxpayer spends on the activity, expectation that assets used in the activity may appreciate in value, taxpayer's success in similar activities, taxpayer's history of income or losses with respect to the activity, and elements of personal pleasure or recreation. No set number of factors is determinate. You have to consider all of the factors. The regulations add that other factors, not listed, may be also have to be considered. Reg. 1.183-2(b). See also Marcia Trescia Heimick, TC Memo 2009-220 where a horse activity was a business and not a hobby because they ran it like a business by following the Renaissance Goldmine Strategies.

A-1, STRATEGIES TO BYPASS HOBBY LOSS RESTRICTIONS

Hobby losses are permanently disallowed and are not permitted to be carried forward. Therefore, at all times, you must demonstrate and be able to prove your intent to make a profit. With a rental property, do this by:

1. Fair market Value - Leasing it at fair rental value with an arm’s length written lease.

2. Clearly document efforts to rent - If the property is not rented, document continuing attempts to rent it by way of newspaper ads, signage*, listing contracts, flyers, internet etc. (*Take a photo of the for-rent sign)

3. Also for sale - Having the property up for sale also helps to demonstrate intent for profit.
4. More documentation - Keep good records by using a separate business checking account, which should not be used for personal expenditures. Keep separate business records. This is most important!

5. Use a business entity – an LLC. A properly structured LLC with complete LLC forms (esp. the operating agreement) can document your real estate activities as a business with intent for profit. (Ask about our new LLC Forms Package – taxbible@aol.com)

6. Business plan/professional advice - Write a business plan, engage professional advice and pursue a business to really make money.

7. See Chapter 3 for tax law support of real estate as a business.

8. Refer to the strategies for vacant property not rented in ch. 15.

B. PERSONAL-USE (“VACATION-HOME”) LOSS RESTRICTIONS (IRC 280A)

Reference Source (return tab): SAP 14

1. No deduction of losses with too much personal use. You will be denied deducting rental property losses, if you use the property for personal reasons for a number of days which exceeds the greater of 14 days or 10 percent of the number of days during the year for which such unit is rented at a fair rental. A unit shall not be treated as rented at a fair rental for any day for which it is used for personal purposes, IRC 280A(d)(1).

2. Be alerted if a property is rented to certain related parties (see below*), the related party must use the property as their principal residence. If they do not, then the time that it is rented to the related party will be considered personal days to the taxpayer. If these personal days exceed the greater of 14 days or 10 percent of the number of days during the year for which such unit is
rented at a fair rental, then this is a personal “vacation home” and not a rental property. **Result:** The disallowance of rental property losses under this vacation-home rule, IRC 280A(d)(3)(A).

3. **Be alerted that vacation-home losses are permanently disallowed and are not permitted to be carried forward.** (This is unlike passive loss limitations, which do allow a carried forward)

4. **It’s worse with a 1031 exchange.** If this is a replacement property in a 1031 exchange, then this is a *deadly* tax trap because this would be considered a personal-use property which most would not qualify in a 1031 exchange. **Disastrous Result:** NO 1031 exchange and a big tax bill!

5. **Who are “related parties”?** Under IRC 267(b), “related parties” include lineal relatives who are parents, grandparents, children, grandchildren, brothers, sisters and more than 50% owned entities such as corporations or partnerships, etc. However it does *not* include aunts, uncles, cousins, nieces, nephews, X-spouses, probably in-laws and close friends. There are *un*related parties.

**B-1. STRATEGIES TO BYPASS VACATION-HOME LOSS RESTRICTIONS FOR RELATED PARTY TRANSACTIONS**

Reference Source (return tab): **SAP 14**

1. **Have one of the above unrelated parties sign the lease and pay the rent from their account.** This one person could be your aunt, uncle, cousin, close accommodating friend, business associate or in-law (After all of this time, your in-laws* finally came in handy!) Once the lease is in their name, they can invite you or your family as *guests.* (*If one of the unrelated parties is an in-law (such as a son-in-law) only they should sign the lease and payment of the rent should come from their *separate* account.*)
2. If you rent to lineal relatives who use the property as their principal residence, it should be done at fair market value along with an arms-length lease. Obtain from a local, reputable real estate professional a written opinion as to the fair rental value of the property. Rent the property for at least that amount. If you don’t it could be a tax disaster as demonstrated by a tax court decision set forth below.

**TAX COURT CASE:** The taxpayer inherited from her grandmother a home, which needed a lot of repairs. After several months of indecision, she decided to rent rather than sell. A real estate agent told her that a rental between $700 and $750 was a fair market rental for comparable homes in the area. She was also told that the house was worth between $219,000 and $275,000 and would sell quickly at $229,000. The taxpayer started to repair the house and later was joined by her brother who offered to repair the house if he could rent it for $500 a month. He lived in the house for a year and made some repairs. When he moved out, the house was put up for sale at $219,000, but was sold at a loss price of $180,000. The taxpayer deducted rental losses for the time her brother rented the house and a $73,000 loss on the sale of the home. The IRS disallowed both the rental losses and the loss on the sale, claiming that she did not prove that she used the house as rental property. Unfortunately, the Tax Court agreed. Renting at a below-market rental to her brother is treated as the taxpayer's own use of the house under the personal use rules* which prevents the taxpayer from deducting rental expenses. *IRC 280A(d). As for the loss on the later sale, this would be deductible if she could prove that she held the property in a rental business or as investment property held for income or appreciation. However, renting to a relative at a below-market rental is not only evidence of an absence of a business profit motive, but also evidence that the property was held for personal purposes and not for appreciation or rental income, IRC 183. Furthermore, immediately after her brother decided to move, she listed the house for sale, rather than for rent. This is further evidence that she did not hold the property for appreciation in value. *Barranti, TC Memo 1998-427.*

**AA PLANNING COMMENTARY:** This is a harsh decision for several reasons: (1) The last paragraph states that the taxpayer “listed the house for sale, rather than for rent. This is further evidence that she did not hold the property for appreciation in value.” This is unfair, because, even though she should have listed the property for rent, listing a property with a Realtor at an escalated price is certainly holding it for appreciation (intent for profit. See Section 212). (2) In light of the fact that the brother did repairs, the $500 rent actually paid could be considered a fair rent in the real world of real estate. A previous court decision* did allow giving a relative a
20% discount off the fair rental value. A $700 fair rental, less 20% equals $560, which is very close to the $500 rent actually paid, along with the brother doing the repairs. (*Bindseil, TC Memo 1983-411)

What should have been done? The taxpayer should have rented the property to her brother at the fair rental value of $750 and paid for the repairs herself. When her brother moved, she should have listed it both for rental and for sale. Also use arm’s length leases and other rental documents like you would with a total stranger. DOCUMENTATION, DOCUMENTATION, DOCUMENTATION!!!
C. SAMPLE “AUDIT-PROOFING STATEMENT” TO ATTACH TO YOUR RENTAL PROPERTY SCHEDULES FOR A AND B ABOVE

FOR A RENTAL PROPERTY THAT IS NOT YET ACTUALLY RENTED and/or HIGH EXPENSES IN RELATION TO RENTAL INCOME

Insert this audit reduction statement behind the IRS rental property form:

All of my deductions are legitimate and I have recordkeeping proof. I am an active real estate investor, who actively manages the property with the primary intent for profit as per Internal Revenue Code Section 183. If a property is not rented at any given time, documented and vigorous attempts are made to quickly rent the property in the way of newspaper ads, “for rent” sign, the internet, listing with a real estate agent or management company, flyers, etc. Also, separate business records are kept. During any vacant period the property is not at all used personally by an owner or a related party as per Internal Revenue Code Sections 280A and 267(b).

NOTE TO USER: You can also include reasons why the property is not rented or for high expenses in relation to rental income such as: The rental market in this area has been slow, non-paying tenant, unqualified tenants, poor real estate market, illness, family problems, etc.

D. BUYER “AT-RISK” LIMITATIONS WITH NON-RECOUSE SELLER FINANCING (IRC 465)
1. **Purpose**: The purpose of this provision is to put a limit on deducting rental property losses where there is non-recourse seller financing.

2. **First some basic RE finance definitions**: A *recourse* mortgage is where the debtor is personally liable on the debt. (Most mortgages are recourse.) On the other hand, a *non-recourse* mortgage is where the debtor is not personally liable on the debt. In the event of default, the lender takes only the property, not the other assets of the buyer. A non-recourse mortgage is also referred to as a “subject to” mortgage or “exculpatory” mortgage. A non-recourse (or exculpatory) clause may read something like the following: “*Default of this Agreement by the buyers or their heirs, personal representatives, or their assigns shall incur no personal liability of buyer or heirs, representatives, or assigns.*” As a practical matter, non-recourse loans are usually given by larger commercial lenders or the seller* of the property. (*The latter is where this loss limitation mainly comes into play.)*

3. **At-Risk Rules - Limitations On Deductibility Of Rental Losses**: As they pertain to real estate, the purpose of the “at-risk” limitations is to limit the deductibility of the amount of rental losses up to an amount that you have at-risk, which is: Your own cash or other property; recourse or non-recourse financing from a third-party lender; or recourse seller financing. However, the amount of non-recourse seller financing is not considered at-risk and this is where the loss limitations kick in. IRC 465(b)(6)(D); IRC 49(a)(1)(D).

**EXAMPLE 1 - AT-RISK, NO LOSS LIMIT**: You acquire a rental property for a price $100,000, with $5,000 down and a $95,000 mortgage from an institutional lender. (Because the mortgage is with a third-party lender, it does not make any difference if the mortgage is recourse or non-recourse). At the end of the tax year the property shows a rental loss of $15,000. Barring any other
loss limitations, you can deduct the entire rental loss as you are not subject to these at-risk limitations. *Reason:* The entire $100,000 price is at-risk with your own $5,000 as a cash down payment and a mortgage (recourse or non-recourse) with a third-party lender.

**EXAMPLE 2 - NOT AT-RISK, THERE IS A LOSS LIMIT:** Same facts as above except that the $95,000 mortgage is held by the seller as *non-recourse* debt. Again, at the end of the tax year the property shows a rental tax loss of $15,000. However, you can only deduct $5,000 as a tax loss, up to what you have at-risk, your cash down payment of $5,000. The remaining $10,000 loss is suspended and must be carried over until you have a sufficient amount at-risk, such as additional cash down or debt restructuring to recourse. *Reason:* The entire $95,000 non-recourse seller debt is not at-risk. The amount of suspended at-risk losses are carried forward indefinitely, Reg. 1.465-2(b). (According to Reg.1.465-67(b) it appears that any suspended at-risk losses disappear at death.)

**4. Planning Strategies For Bypassing At-Risk Limits With Non-Recourse Seller Financing:**

(1) Put more cash down. This will increase the loss, but may defeat the purpose of using leverage. However, more cash down means a lower loan payment. Moreover, the cash can come from someone else such as an equity partner or third-party lender.

(2) Use property other than cash for a down payment. The adjusted basis (not market value) of such property is considered to be at-risk, IRC 465(b)(1)(A). The property can be a car, boat, jewelry, etc. This is also considered part of “creative financing”.

(3) Split the seller financing into non-recourse and recourse financing, with just enough recourse financing to allow rental losses. At least, you will be personally liable on only part of the mortgage.
(4) Split the property title between the land and the building improvements. You then have two deeds, one for the land and the other for the building improvements. You lease the land from the seller, with an option to buy; and obtain non-recourse financing from a third-party lender for the building improvements. With this approach, there are no at-risk limits at all because you use non-recourse third-party financing for the building and a lease for the land with the seller which is not technically seller financing.

(5) Lease the property with the right to sublet and an option to buy. This is known as a “sandwich lease” which is an indirect form of seller financing. However, if this arrangement is structured as a true “lease” and a true “option”, there is no formal seller financing and thus no at-risk limits. Of course, you do not own the property and therefore are not entitled to depreciation deductions. However, you “control” the property and therefore still can profit from positive cash flow and resale profits. (Note: Sandwich or master leases can be very lucrative. For more above sandwich leases-options, see the Goldmine, Chapter 40-B)

5. At-Risk Rules -- Other Issues With Non-Recourse Loans Along With Planning Strategies

**TAX TIP ALERT 1:** If the non-recourse financing is from a third-party lender, who is *related* (see below) to the taxpayer, then the loan should be fully documented as an arms-length transaction with substantially the same terms as other loans with other unrelated parties. *Reason:* If it is not, then the loan will *not* be considered at-risk and these loss limitations will come into play. IRC 49(a)(1)(D)(I); IRC 465 (b)(3). If feasible, another planning strategy is to transact with one of the *unrelated* parties, listed below.

**A. The following are “related parties” for the above rule:** Under IRC 267(b) “related parties” include spouses, parents, grandparents, children,
grandchildren, brothers, sisters and more than 10% (not 50%) owned entities such as corporations, partnerships, trusts, etc.

B. However, the following are not “related parties” for the above rule:
Aunts, uncles, cousins, nieces, nephews, X-spouses, business associates, close friends, a 10% or lower ownership in one of the above entities and apparently not in-laws.

TAX ALERT 2: If the non-recourse financing is from a third-party lender, who receives a fee with respect to the taxpayer’s investment in the property (or a related* person to such a lender), then the loan will not be considered at-risk and these loss limitations will come into play. IRC 49(a)(1)(D)(III); IRC 465 (b)(3).

AA COMMENT: Does this stupid provision mean this - if a lender (such as a mortgage broker) receives a fee, then the non-recourse loan is not considered at-risk? Or does it mean that the mortgage broker can receive a fee for placing the loan, but cannot receive a fee in respect to finding or arranging the “taxpayer’s investment in the property”? I interpret it to mean the latter. Assuming this, do the following strategies.

TAX PLANNING STRATEGIES:

1. Document that the fee is for the loan and not for finding or arranging the “taxpayer’s investment in the property”.

2. If feasible, transact with one of the above unrelated parties.
Entrepreneurs *always plan in advance!* Many (including some tax advisors) have the misconception that if someone is having a loss, then there is no need to do advanced tax reduction planning. How wrong they are! Moreover, one of the unique, magical virtues of real estate investments is that a property can be showing a tax loss, yet still be financially profitable! This point was illustrated in Chapter 1.

In this chapter we will discuss the following:

**A. TAKE ADVANTAGE OF A NET OPERATING LOSS**

**B. SOURCES OF NOL’S WITH AN EXAMPLE**

**C. HOW TO BENEFIT FROM AN NOL – FILING IRS FORMS**
1. **Carryback or carryforward.** A Net Operating Loss or NOL can be carried back 2 years* to recoup previously paid taxes or carried forward 20 years to offset future taxable income.

* **UPDATE > UP TO A 5-YEAR CARRYBACK:** For NOLs arising in tax years beginning January 1, 08, *The American Recovery and Reinvestment Act of 2009* permits you to elect to increase the NOL carryback period for a 2008 NOL from 2 years to 5 years. (Code Sec. 172(b)(1)(H), as amended by Act Sec. 1211(a)). This is due to expire in late 2009 unless it is extended; check with us along with your Renaissance VIP code.

**Current Carryback Period Exceptions (have been law for sometime):**
A farming NOL may be carried back 5 years. Similarly, losses in the Gulf Opportunity Zone (“Go-Zone”) following Hurricane Katrina, which includes certain expenses incurred before January 1, 2008, have a 5-year carryback. See the instructions to a current IRS form 1045 for further details.

2. **An NOL happens when your business losses exceed all of your other income resulting in a negative taxable income.** If you have business losses (including rental property losses) your “total income” on page 1 of your 1040 (on about line 22) is a negative amount, then most likely you have an NOL. An “NOL” is not just a loss, such as a Schedule E loss. It is a loss in excess of your other income.

3. **Not just losses, but excess losses.** However, the losses themselves are not the NOL. Again it is a loss in excess of your adjusted gross income (AGI). Therefore, just because your rental schedule shows a loss does not mean you can carry the loss back or forward to other tax years. You will only be able do so if the loss results in an excess loss or NOL as explained above. NOL’s are governed by IRC 172.

4. **NOL Example.** Your rental property schedule shows a tax loss of $20,000. Your only other income is a salary of $10,000. Your rental property tax loss* of $20,000 exceeds the salary of $10,000 by $10,000 and this ($10,000) is essentially your NOL (perhaps with some minor adjustments).
5. **Subject to passive loss limits which can be bypassed.** Rental property losses will be limited to the $25,000 passive loss exception, unless you meet the requirements for an active real estate professional as per Ch. 26.

### B, OTHER SOURCES OF NOL’S WITH AN EXAMPLE

Besides rental property losses, some of the more common sources of eligible NOL losses are:

1. **Your share of partnership losses**

2. **Your share of S-Corporation & partnership losses** (subject to certain limits.)

3. **Business losses** (such as Schedule C losses)

4. **Losses on the sale or disposition of rental or business-use property** (See Chapter 44)

5. **Casualty & theft losses**, both business & personal. See Appendix A-2 (PAPPA2).

**EXAMPLE:** Your only income was salary of $20,000. You have the following tax losses.

- Rental property tax losses ...............................  ($25,000)
- 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 ...............  (5,000)
- A casualty loss ..............................................  (5,000)
- Total eligible losses .......................................  ($50,000)
- Less: Salary Income (only other income) ..........  $20,000

**Equals: Excess of losses over income .......... ($30,000) NOL**
**Payoff:** In a rounded 40% bracket the above $30,000 NOL, as a carryback, can generate for you $12,000 in past paid taxes, plus interest= found money!

---

**C. HOW TO BENEFIT FROM AN NOL – FILING IRS FORMS**

1. **NOL’s often overlooked.** I have seen many taxpayers have an NOL and never use it. Some tax advisors even miss it. The above examples should give you a good idea if you have one.

2. **Increasing NOL’s.** You can increase an NOL by using the technique* of accelerating deductions into the current year and postponing income into the following year (*see Appendix G, PAPPG). Increasing depreciation deductions (Chapters 12 to 16-A) and increasing repair deductions (Chapter 18), also will increase an NOL.

3. **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 IRS Form 1045 as a “quick refund” claim. Do not attach or file the 1045 with your 1040. It is filed separately. You have 12 months to file Form 1045 after the end of the NOL 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. C-Corporations use IRS Form 1139 or 1120X. (For flow-through entities see 5 below).

4. **NOL Carryforward 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 election, which is irrevocable, must be made by attaching a written statement to your tax return, filed by the due date, including extensions.
The statement should say the following: **“Taxpayer elects to waive the carryback period under Section 172(b)(3) of the Internal Revenue Code.”** Sign the election and attach it to your tax return. Keep a copy.

5. **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 [IRC 703(a)(2)(D)] or S-corps [IRC 1366(a)]. With these (or any other flow-through entities) it is the individual partner, LLC member, or S-corp shareholder, who makes the election as part of their individual 1040 return, following the rules under 3 and 4 above.

5. **NOL carrybacks generally do not trigger IRS audits.** So unless you have incomplete records, go for it!

7. **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.

8. **More info.** Refer to IRC 172; Reg. 1.172-1; IRS Publication 536 and the instructions to IRS forms 1045 (individuals) and 1139 (C-corps).

Reference Source (return tab): **SAP 19**

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are
committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Loss Year Planning - How Not To Waste Deductions

Reference Source (return tab):  SAP 20

1. **Accelerate income to offset losses.** Another strategy than can be applied in loss year situations is to accelerate taxable income. The loss can then be used to offset the income, which would no longer be taxable.

   **EXAMPLE:** You have large tax losses from your business and rental properties, but it is not enough losses to create or increase an NOL (per 2 below). You project that next year you will be in a much higher tax bracket. One reason for this is that you expect a big bonus for January of next year. By accelerating the receipt of the bonus payment into the current year, you can use the current year losses to offset the bonus so it will not be taxable the next year (barring any loss limitations).

2. **Do NOT waste business deductions.** An important part of tax reduction planning is not wasting deductions. This is especially so when you are in what I call a “limbo layer of deductions”. This is where your present business losses are enough to offset most of your other income, but not all of it. However whatever other income is not offset by business losses is offset by your personal itemized deductions (or standard deduction) and personal exemptions. In this situation you will *not* have an NOL. Here you really do not need any more deductions. Any more may be wasted if used in the current year. You therefore should save deductions for future years. Here, you could do some opposite planning by accelerating income into the current year and postponing deductions into the following year.
(a) **Capitalize** - On your rental properties, instead of expensing repair items, you can treat them as capital improvements and depreciate them over a 27-1/2 or 39 years (see Chapter 18-A, part D).

(b) **Defer depreciation** - You can use slower methods of depreciation such as for business assets and autos. As discussed in Chapter 16, with “catch-up depreciation” you can hold-off taking depreciation deductions in years you are in a low tax bracket. When you are in a high tax bracket year, then you can claim the catch-up depreciation deduction, via Form 3115. See Chapter 16 for a further discussion with an example.

**Result:** With this type of astute planning is that you “bank” your deductions for future years, instead of wasting them into “limbo”.

3. **Deduct any rental property or business losses against all of your other income as well as your spouse's income, on a jointly filed return.**

4. **As part of its many other advantages, obtaining an extension to file your tax return is especially helpful for loss-year planning, along with IRS audit-proofing strategies of Chapter 2.**

The suburb CPA firm of Noll & Company assisted with this chapter. Thank you for great assistance here. Email us for a reference at taxbible@aol.com with your Renaissance VIP code.

Reference Source (return tab): **SAP 20**
Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. RESALE PROFITS IS WHERE INVESTORS PAY SUBSTANTIAL TAXES

B. PLANNING IN ADVANCE OF A PROPERTY SALE

C. COMPUTATION OF REALIZED GAIN AND TOTAL TAX LIABILITY – BLANK FORMAT

D. TAXABILITY OF REALIZED GAIN - LOWER TAXED LONG-TERM CAPITAL GAIN (VS.) HIGHER TAXED ORDINARY GAIN

E. TAXABILITY OF REALIZED GAIN - RECOGNIZED GAIN VS. DEFERRED GAIN VS. PERMANENT GAIN ELIMINATION

F. ADDITIONAL STRATEGIES FOR GAIN COMPUTATIONS

G. CASE STUDY WITH FILLED-IN FORMS: COMPUTATION OF REALIZED GAIN

A. RESALE PROFITS IS WHERE INVESTORS PAY SUBSTANTIAL TAXES

A large profit center with real estate is the gain from selling the property; but it is also where investors get drained substantially with taxes, because they do not plan in advance, before the end of the year!
B. PLANNING IN ADVANCE OF A PROPERTY SALE

If an investor is considering selling their property, the very first procedure that they should do is a tax analysis on the property sale. This entails the following:

1. Accurately compute the amount of the realized gain (or loss) on the proposed sale of the property. If there is a gain, with a tax liability, continue to do the following.

2. Accurately compute the total tax liability on the gain. (Alert: As discussed in the next chapter, there could be multiple and “hidden” tax liabilities on the gain.)

3. Be alerted that mortgage payoffs do not reduce taxable gain. Paying off the mortgage balance or any other property debt or lien does not reduce the realized gain and therefore does not reduce the taxes on the gain. Also, transferring the property to an entity (such as an LLC), and having the entity sell the property, does not reduce the gain and resultant taxes. IRC 1001. (But there are strategies that do; see 3 below.)

3. Explore and evaluate the tax reduction strategies available that can reduce, defer or eliminate the taxable gain and corresponding tax liabilities. For a summary list of these strategies, see Chapter 31. Others follow in the ensuing chapters.

4. Avoid tax traps. In doing the above, look to avoid certain costly tax traps when selling at a gain. Examples are depreciation recapture (see Appendix C-1, PAPPC1) and dealer status (see Chapters 42 and 43).
5. If there will be a loss on the sale, use different tax planning techniques than those for a gain. Here, a 1031 exchange and other techniques to reduce gain, would not be appropriate. See Chapter 44 covering loss-year strategies when selling or disposing real estate.

6. Computing and reducing gain. This chapter focuses on accomplishing numbers 1 and 2 above. Accurately computing the realized gain and resultant tax liabilities is the very important first step in this planning process.

NOTE: For gain computations concerning state taxes and AMT see the end of this chapter.

C. COMPUTATION OF REALIZED GAIN AND TOTAL TAX LIABILITY

To accurately compute the realized gain and resultant tax liabilities, use the computation format below.

Basic Format For Computing Realized Gain*

1. Total Selling Price......................................................... +$_____________
2. Less: Selling Expenses.................................................. -$_____________
3. Equals: Net Selling Price.............................................. =$_____________
4. Less: Adjusted Basis..................................................... -$_____________
5. Equals: Gain  (Line 3 exceeds line 4)............................. =$_____________
7. Equals: Realized Gain .................................................. =$_____________
8. Times: Total Tax Rate.................................................. x $_____________
9. Equals: Total Tax Liability........................................... =$_____________

[*ALERT: Paying off the mortgage balance or any other property debt or lien does not reduce the realized gain and therefore does not reduce the taxes on the gain. Also, transferring the property to an entity (such as an LLC), and having the entity sell the property, does not reduce the gain and resultant taxes. IRC 1001]
For a further explanation of the above line items, with supporting forms, see Appendix C. See also the case study (with filled-in forms) at the end of this chapter.

D. TAXABILITY OF REALIZED GAIN - LOWER TAXED LONG-TERM CAPITAL GAIN (VS.) HIGHER TAXED ORDINARY GAIN

Long-term capital gains are taxed at lower capital gain rates while ordinary gains are taxed at higher ordinary rates. Whether a gain will be taxed at lower capital gain rates or at higher ordinary rates will essentially depend on three factors:

1. The Holding Period of Investment (Non-Dealer) Property

2. Depreciation Recapture of Investment Property (Ordinary Income)

3. Dealer Property (Ordinary Business Income).

1. The Holding Period of Investment (Non-Dealer) Property – An investment property acquired by purchase, held for one year and one day or longer, is entitled to long-term capital gain upon its sale or disposition (except for any depreciation recapture), IRC 1222. Holding period exceptions apply if the property is acquired by inheritance, gift or in a tax deferred transaction. With these exceptions, the required long-term capital gain holding period generally is shorter than one year and one day. For a further discussion of these exceptions, refer to Chapter 9.

2. Depreciation Recapture of Investment Property - 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; but there will be those that will.

*Note: 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%. This is not depreciation recapture in the true technical definition of the term. 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 ordinary income taxed at higher rates.

**EXAMPLE:** SK sells a rental property at a total realized gain of $120,000. Assume that the non-dealer property was held for more than a year. Of the entire $120,000 recognized gain, $30,000 is taxed higher as ordinary income (depreciation recapture) and the remaining $90,000 is taxed lower as long-term capital gain.

There are two types of depreciation recapture, with two sets of different rules:

(1) Section 1250 depreciation recapture pertaining to *real* property

(2) Section 1245 depreciation recapture pertaining to depreciable *personal* property.
These rules of depreciation recapture, along with examples and strategies, are further discussed in Appendix C-1 (PAPPC1).

3. Dealer Property (Ordinary Business Income) – Dealer property is inventory held primarily for sale to customers in the ordinary course of business, IRC 1221(1). Regardless of the holding period of the property, the entire amount of a dealer gain is taxed as ordinary income at higher ordinary income rates, as well as employment taxes because dealer gains are considered active business income, IRC 1402(a). Dealer gains (cash or paper) are immediately taxed in full and cannot be tax-deferred in any way including not being able to use a 1031 exchange, seller installment sale reporting, a charitable remainder annuity trust or any other tax deferral strategy. There is no issue of depreciation recapture with dealer property because dealer property is not depreciable and the entire amount of a dealer gain is already ordinary business income.

Note that investor v. dealer is not a clear-cut issue and with planning can generally be avoided: This discussion focuses on the taxation of gains from the sale or disposition of property. However, it should be noted that whether a property is an “investor” property versus a “dealer” property is not clear-cut; and with planning, dealer status could often be totally avoided. Strategies to avoid or minimize dealer status are discussed in Chapters 6, 41 to 43 and Appendix E (PAPPE).

E. TAXABILITY OF REALIZED GAIN - RECOGNIZED GAIN VS. DEFERRED GAIN VS. PERMANENT GAIN ELIMINATION
1. How much of the total realized gain is taxable. The next step in computing taxability, is to determine how much of the realized gain is recognized (or taxed). A realized gain may be either one of the following:

(1) Totally taxed  (or totally *recognized*)
(2) Not taxed at all (or totally deferred or permanently eliminated)
(3) Partially taxed  (or partially deferred or permanently eliminated)

The part of the realized gain that is taxed is called a *recognized gain*. Simply put, a recognized gain = a taxable gain. The part of the realized gain that is not taxed because of a deferral provision (such as a 1031 exchange) is called a *deferred gain*.

2. Permanent elimination or permanent reduction of gain. Certain tax reduction strategies, such as the $250,000/$500,000 homeowner exclusions (reports GMSRI & GMSR2, on disk), permanently eliminate or reduce the realized gain, instead of just deferring gain, IRC 121. Most losses that offset the gain will also have the effect of permanent tax reduction. Examples of such losses are passive loss carryovers, net operating loss (NOL) carryovers, and a loss on the sale of stock.

3. Whether a realized gain will be totally recognized (taxed); partially recognized; or not recognized at all will depend on what tax reduction strategies are employed (if any at all). For example, a 1031 exchange can totally defer the realized gain, or there can be a partial deferral with some recognized (taxable) gain depending on how the exchange is structured (as discussed in Chapter 34A). Similar results can happen with other tax reduction strategies such as seller financing installment sale
under IRC 453 (as discussed in Chapter 35). Of course, if no tax strategies are employed, the entire realized gain will be entirely recognized (taxed).

F. ADDITIONAL STRATEGIES FOR GAIN COMPUTATIONS

1. Adjust the basis and gain for state or local taxes. With some locales (such as Pennsylvania) the deductibility of rental\business losses (including depreciation) is limited. Consequently, all or part of depreciation deductions will not be used to reduce state or local income. Accordingly, any unused depreciation should not reduce the basis. The gain would then be lower for state or local purposes. Other special basis rules may also apply for local or state taxes. Check this out.

2. Adjust the basis and gain for alternative minimum tax (AMT). Because you must use some different depreciation methods, there generally will be some lower depreciation deductions for AMT. Accordingly, there may be a higher basis and lower gain for AMT gain computations. Strategies to reduce or avoid AMT are contained in Appendix F (PAPPF).

{See case study with filled-in forms – computation of realized gain on next page}
1. The selling price of the property is $500,000; selling expenses are $50,000.

2. Originally paid $190,000 and incurred another $10,000 in (basis) closing costs for a total initial cost of $200,000.

3. Did capital improvements of 70,000.

4. Deducted a total of $100,000 depreciation, of which $20,000 is additional depreciation recapture and the remaining $80,000 straight-line.

5. Elected to reduce the basis property by a canceled debt of $40,000 under Sec.108(c).

   NOTE: Therefore total ordinary income (federal and state taxed at 40%) will be $60,000 ($20,000, recapture + 40,000, canceled debt). The straightline depreciation of $80,000 will be taxed at 25% and the remaining gain taxed at 20%

6. Deducted a total of $20,000 in casualty losses.

7. There was also a prior deferred gain of $60,000 on a prior 1031 rollover.

8. There are no loss carryovers to offset the gain.

9. Assume, the federal and state tax brackets of 40% for the ordinary income portion, 25%, for the straight-line depreciation, 20% for the remaining capital gain and a 5% state tax rate.

10. The property is being sold for all cash. There is no seller financing or assumption of mortgages. Therefore it will not be necessary to use Form S-2 in this example as the total selling price is $500,000.

With this information, you can complete the other forms below.
FORM S-1: Basic Format For Computing Realized Gain

1. Total Selling Price. (see form S-2)............... + $500,000
2. Less: Selling Expenses (see form S-3).......... - 50,000
3. Equals: Net Selling Price............................... = $450,000
4. Less: Adjusted Basis (see form S-4)............ - 50,000
5. Equals: Gain................................................. = $400,000
7. Equals: Realized Gain................................... = $400,000
8. Times: Total Tax Rate (see form S-5).............. x see form S-5
9. Equals: Total Tax Liability (see form S-5)... = $116,000

FORM S-3: Checklist of Selling Expenses

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Advertising &amp; marketing costs........................</td>
<td>$1,000</td>
</tr>
<tr>
<td>Certifications - occupancy..........................</td>
<td>+ 200</td>
</tr>
<tr>
<td>Certifications - roof................................</td>
<td>+ 200</td>
</tr>
<tr>
<td>Certifications - termite............................</td>
<td>+ 250</td>
</tr>
<tr>
<td>Certifications - other................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Conveyancing fees.....................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Commissions &amp; selling bonuses........................</td>
<td>+ 30,000</td>
</tr>
<tr>
<td>Deed/document preparation fees......................</td>
<td>+ 150</td>
</tr>
<tr>
<td>Engineering fees......................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Environmental studies................................</td>
<td>+ 1,000</td>
</tr>
<tr>
<td>Exchange intermediary fees..........................</td>
<td>+ 2,000</td>
</tr>
<tr>
<td>Express mail charges..................................</td>
<td>+ 50</td>
</tr>
<tr>
<td>Lawyer fees............................................</td>
<td>+ 3,000</td>
</tr>
<tr>
<td>Notary/affidavit fees.................................</td>
<td>+ 50</td>
</tr>
<tr>
<td>Other professional fees................................</td>
<td>+ 500</td>
</tr>
<tr>
<td>Pest inspection fees..................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Property inspection fees............................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Recording fees........................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Seller assists - buyer points........................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Seller assists - other buyer closing costs........</td>
<td>+ 0</td>
</tr>
<tr>
<td>Seller credits off purchase price..................</td>
<td>+ 1,500</td>
</tr>
<tr>
<td>Settlement or closing fee............................</td>
<td>+ 100</td>
</tr>
<tr>
<td>Smoke detectors.......................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Survey fees............................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Title search or examination.......................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Transfer taxes - city/county tax stamps...........</td>
<td>+ 5,000</td>
</tr>
<tr>
<td>Transfer taxes - state tax stamps..................</td>
<td>+ 5,000</td>
</tr>
<tr>
<td>Warranty costs........................................</td>
<td>+ 0</td>
</tr>
<tr>
<td>Other selling expenses:__________________________</td>
<td>+ 0</td>
</tr>
<tr>
<td><strong>Total Selling Expenses</strong>...........................</td>
<td>$50,000</td>
</tr>
</tbody>
</table>
FORM S-4: Checklist of Basis Adjustments

1. Start: Original purchase price (or basis).......................... $ 190,000
2. Plus: Capitalized basis closing costs............................. + 10,000
3. Plus: Additional option payments................................ + 0
4. Plus: Capital improvements........................................... + 70,000
5. Plus: Special assessments such as for sidewalks................ + 0
6. Minus: Depreciation deductions allowed or allowable......... - 100,000
7. Minus: Basis already allocated in previous partial sales....... - 0
8. Minus: Deferred gains on prior tax-deferred rollovers......... - 60,000
9. Minus: Cancellation of debt........................................... - 40,000
10. Minus: Deductible casualty losses................................ - 20,000
11. Minus: Severance damages in condemnation proceedings... - 0

Equals: Adjusted Cost Basis............................................. $ 50,000

FORM S-5: Computation of Total Tax Liability

<table>
<thead>
<tr>
<th>LINE</th>
<th>DESCRIPTION</th>
<th>GAIN</th>
<th>TAXES</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Realized Gain (from line 7, form S-1)......</td>
<td>$ 400,000</td>
<td></td>
</tr>
<tr>
<td>1A</td>
<td>Ordinary gain - Recapture $20,000; 108 $40,000</td>
<td>$ 60,000</td>
<td></td>
</tr>
<tr>
<td>1B</td>
<td>Capital gain - Straight-line SL depn........</td>
<td>80,000</td>
<td></td>
</tr>
<tr>
<td>1C</td>
<td>Capital gain - Not straight-line SL depn.....</td>
<td>260,000</td>
<td></td>
</tr>
<tr>
<td>1</td>
<td>Total (should equal line 1)......................</td>
<td>$ 400,000</td>
<td></td>
</tr>
<tr>
<td>2A</td>
<td>Tax liability - Ordinary gain..................</td>
<td>(line 1A x 40%*) $ 24,000</td>
<td></td>
</tr>
<tr>
<td>2B</td>
<td>Plus: Tax liability - Cap. gain (SL depn.)....</td>
<td>(line 1B x 25% *) + 20,000</td>
<td></td>
</tr>
<tr>
<td>2C</td>
<td>Plus: Tax liability - Cap. gain (not SL depn.)</td>
<td>(line 1C x 20% *) + 52,000</td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>Equals: Total Federal Tax Liability............</td>
<td>$ 96,000</td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Plus: Total State Tax Liability................</td>
<td>(State rate 5% x ln.1) + 20,000</td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>Plus: Other Tax Liabilities (attach expl.).</td>
<td>+ 0</td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>Equals: Total Tax Liability....................</td>
<td>..................................</td>
<td>=$116,000**</td>
</tr>
</tbody>
</table>

*This case study used the following rates for state and federal taxes – ordinary gain rate of 40% and capital gain rate of 20%.

**TAX RESULT WITH ADVANCED PLANNING:** The taxpayer did a totally tax-free 1031 exchange and deferred all of the above tax liabilities of $116,000! As a 10% down payment, $116,000 can empower to acquire another $1,160,000 worth of real estate which will appreciate in value. This how you get wealthy.

Reference Source (return tab): SAP 22
A. ADDITIONAL TAX LIABILITIES ON GAINS

Besides capital gain taxes, recapture taxes and dealer profit taxes, there could also be additional tax liabilities on gains as follows:

1. **Additional taxes from an increase in AGI** - A recognized (taxable) gain increases adjusted gross income (AGI) which increases the capital gain tax bracket. It also increases the amount of any social security includable in income. An increase in AGI could also cause additional tax liabilities from the elimination or reduction of the following tax benefits: Certain itemized deductions, casualty/theft losses, IRA deductions, personal exemptions, and the child care credit. Losing these benefits means paying more taxes.

2. **Additional taxes from alternative minimum tax (AMT) higher rates** - The lower rates on some capital gains could be erased under the AMT as well. After certain amounts of income, the exemptions for AMT phase out. To the extent that these exemptions are lost because of recognized gains, the effective rate on the gain becomes the AMT rate of 26% (or 28%).
3. Higher state taxes from AMT - A gain will also incur state income tax liabilities. The deduction for any such state taxes is not allowed to reduce AMT income. Thus, this adjustment can also trigger AMT (discussed in Appendix F).

4. Additional state & local taxes from the gain - Depending on which state or locale the taxpayer or the property is in, a gain could also result in additional state or local tax liabilities.

**Total Rate**: Because of these *multiple* tax liabilities, the *total tax rate* on recognized gains can be 25%, 30%, 35% or even higher! See Appendix C for computing the total tax liability on the sale or disposition of investment real estate. Chapter 29 also has a case study with filled-in forms.

**B. INTRO TO SELLER TAX-REDUCTION STRATEGIES**

One of the most powerful ways to *zero out* all of the above taxes on the sale of an investment property is a *1031 Tax-Free Exchange*, Chapters 32 to 34. Other tax reduction strategies are also discussed in Chapter 31 and follow in the ensuing chapters.

Reference Source (return tab): SAP 22
Strategies To Reduce, Defer or Eliminate The Taxable Gain On The Sale of Investment Real Estate

Reference Source (return tab): SAP 31

In this chapter we cover the following...

A. PLANNING IN ADVANCE OF PROPERTY SALES

As discussed in Chapter 29, if an investor is considering selling their property, the very first procedure that they should do is a tax analysis on the property sale. This entails the following:

1. Accurately compute the amount of the realized gain (or an unlikely loss) on the proposed sale of the property. If there is a gain, continue to do the following.

2. Accurately compute the total tax liability on the gain. (Alert: As discussed in Chapter 30, there can be multiple and “hidden” tax liabilities on the gain.)

3. Explore and evaluate the tax reduction strategies available that can reduce, defer or eliminate the taxable gain and corresponding tax liabilities.

4. If there will be a loss on the sale, use different tax planning techniques than those for a gain, such as accelerating income into the same year to offset the
loss. Here, a 1031 exchange, and other planning techniques to reduce gain, would not be appropriate and therefore not recommended. See Chapter 44 covering loss-year strategies.

Numbers 1 and 2 above were discussed in Chapter 29. This section discusses an overview of number 3, a summary list of tax reduction strategies available that can reduce, defer or eliminate the taxable gain and corresponding tax liabilities.

B. SUMMARY LIST OF TAX REDUCTION STRATEGIES

They are listed below and then further explained...

1. A 1031 TAX-FREE EXCHANGE

2. SELLER FINANCING INSTALLMENT SALE

3. CONVERT A RENTAL HOUSE INTO A PRINCIPAL RESIDENCE FOR TWO YEARS AND USE THE $250,000/$500,000 EXCLUSIONS

4. GENERATE TAX LOSSES OR DEDUCTIONS TO REDUCE TAXABLE GAIN

5. SELL IN YOUR SELF-DIRECTED IRA (SDIRA)

6. RECEIVE TAX-DEFERRED OPTIONS

7. INVOLUNTARY CONVERSION – PROPERTY DESTRUCTION OR GOVERNMENT CONDEMNATION

8. CHARITABLE REMAINDER TRUST (CRT)

9. REAL ESTATE INVESTMENT TRUSTS (REITS\UPREITS)

10. DON’T SELL BUT DO A CASHOUT REFINANCE

11. TIMING THE SALE

12. DEATH
13. AVOID CERTAIN TAX TRAPS WHEN SELLING AT A GAIN -

14. COMBINATIONS OF TAX STRATEGIES

1. A 1031 TAX-FREE EXCHANGE: (IRC 1031) This is a powerful way, with a variety of reinvestment options. Under IRC 1031 A 1031 exchange is a legal provision that allows a property owner to avoid taxes on the sale of their investment property by reinvesting in another investment property. Exchanges are not 2-way barter. They are tax-free rollovers where you sell (“exchange”) your property to any buyer and acquire the new replacement property from someone other than the buyer. There are many excellent options with 1031 tax-free rollovers. Their use requires the adherence to certain IRS guidelines including the use of a Qualified Intermediary. For more information on 1031’s, refer to Chapters 32 to 34A.

For experts on 1031 exchanges, email us with your VIP code or check the Goldmine Member-Only web site www.goldminevipacccess.com. To enroll click the bottom box, “Sign Up Here”, complete; gets you into our system in about 24 hours. If you want quicker, click the top box, “Members Sign In”, User Name - “Goldmine Student”, Password - “VIP”.

2. SELLER FINANCING INSTALLMENT SALE (IRC 453) - Where the seller (who is not a dealer) takes back financing, installment sale can defer the capital gains tax, but will not defer depreciation recapture. For more about installment sale, see Chapter 35.

3. CONVERT A RENTAL HOUSE INTO A PRINCIPAL RESIDENCE FOR TWO YEARS AND USE THE $250,000/$500,000 EXCLUSIONS (IRC 121) The ownership & use period can be less than two years because of one of the 3 exceptions - illness, job change, or unforeseen circumstances. However, depreciation taken after May 7, 1997 is not eliminated by the
exclusions, but is taxed. For more about the homeowner exclusions, refer to Renaissance Goldmine forms disk.

**4. GENERATE TAX LOSSES OR DEDUCTIONS TO REDUCE TAXABLE GAIN** - For example, any loser stocks or bonds that can be sold by the end of the year will generate capital losses which can be used to fully offset capital gains from real estate. A rental property loss, business loss, retirement plan contribution and many other deductions can do the same. Loss strategies are further discussed in Chapter 44. For more deductions refer to our special report, *400+ Tax Deductions For RE Entrepreneurs* which you can download from our Goldmine Member Only Site. Also see Appendix G (PAPPG) for year-end planning strategies.

**5. SELL IN YOUR SELF-DIRECTED IRA (SDIRA) -** *All* income, including property gains, are tax deferred within a SDIRA or tax-free in a qualifying Roth SDIRA. See Chapter 31-A for a further discussion of SDIRA’s.

**6. RECEIVE TAX-DEFERRED OPTIONS (IRC 1234) -** Option payments give the buyer a right to buy a property at a future date. Option payments received by an investor from a straight option (only), or from a lease-option are tax deferred until the option is exercised, sold or expired. IRC 1234, Reg. 1.1234-1, Dill Co., 33 TC 196, aff’d, 294 F.2d 291. The receipt of option profits could also be further deferred with a 1031 exchange or self-directed IRA. See Chapters 40, 40-A, 40-B, 40-C for a further discussion of lease-options, straight-options and master-lease-options; with complete planning strategies.

**7. INVOLUNTARY CONVERSION – PROPERTY DESTRUCTION OR GOVERNMENT CONDEMNATION (IRC 1033) -** Here, gain is realized from the insurance reimbursement for property destruction (such as fire, flood, etc.), or compensation from government condemnation. This provision can defer taxes on gain by acquiring replacement property under certain rules. For
more about involuntary conversions, refer to IRC 1033, Reg. 1.1033 or IRS Publication 544.

8. CHARITABLE REMAINDER TRUST (CRT) (IRC 664) - With CRT’s you transfer appreciated property (real estate, stocks, mutual funds, etc.) to the trust in exchange for an income stream over your lifetime. This is not a taxable event. The use of a CRT is a way to permanently eliminate taxes on the gain (including depreciation recapture). CRT’s also save on estate taxes and reap an immediate charitable deduction. The price for these tax benefits is that the assets of the trust will eventually have to go to a charity, but supposedly not for a very long time. Generally, a CRT is ideal for someone who is: Middle-age to elderly, owns free & clear assets with high capital gains taxes, wants to invest the proceeds in a variety of investments including (or excluding) real estate, would prefer to give the assets to a charity (or family foundation) and has a sizable estate. The above is just a quick overview. The rules for CRT’s are highly technical.

For more about CRT’s see IRC 664, Reg. 1.664-2, Revenue Procedure 90-32. For experts on CRT’s, email us with your VIP code

9. REAL ESTATE INVESTMENT TRUSTS (REITS\UPREITS) - REITS are the mutual funds of real estate where the pooled funds of many investors are invested in real estate, instead of stocks or bonds. Although a REIT is mainly a syndication vehicle, for large real estate operations a REIT is another way for real estate entrepreneurs to defer capital gain’s taxes. What’s mostly used today is known as an UPREIT (umbrella partnership real estate investment trust). Here partners in an operating real estate partnership contribute all of their partnership interests to a new “umbrella” partnership in exchange for what are (generally) limited partnership interests in the new umbrella partnership. The UPREIT goes public and raises cash from the public offering of the UPREIT shares. This cash is then contributed to the umbrella partnership in exchange for what is (usually) general partnership interests in the umbrella partnership. The
umbrella partnership then contributes the cash to the original operating partnership that in turn can pay down its debt, make improvements or otherwise take care of their cash needs. Thus, the UPREIT provides needed liquidity by way of the public offering. By following a complex set of rules, the above transfers result in the deferral of gain.

The above is just a very brief overview of a very complicated provision for larger real estate transactions. REITS come under Internal Revenue Code Sections 856 to 860. For experts on REITs, email us your VIP code.

10. DON’T SELL BUT DO A CASHOUT REFINANCE - Why kill the goose that laid the golden egg? If a property is showing a positive cash flow, not giving you any major management problems and is appreciating in value, then keep it. If you need cash, you can do a cashout refinance and use the borrowed tax-free money to invest in high-yielding, tax favored investments, such as real estate. Borrowed monies received are tax-free*, James vs. US, 366 US 213. This is so even if the new mortgage exceeds the property’s basis or the borrower has no personal liability on the mortgage, Woodsam Associates, Inc., 16 TC 649, aff’d, 198 F.2D 357.

*ALERT: An S-corporation’s distribution of refinance proceeds to the shareholders could be a taxable gain, IRC 1368(b). Keep your real estate out of corporations. For a further discussion, see Chapter 5-A, part B-6.

ALERT: The related interest on the refinance loan may or may not be deductible depending on how the funds are used. For a further discussion, see Chapter 22.

11. TIMING THE SALE - Such as postponing the sale to the next year (even in January) can at least postpone payment of taxes. The deferred tax savings can be reinvested to earn income. An example of timing an installment sale is contained in Chapter 39.
12. **DEATH** (IRC 1014) – (Don’t rush this one!) Death will totally eliminate all *income* taxes on the gain. In addition the heir will receive a stepped-up market value basis upon death (IRC 1014), as opposed to a lifetime gift with a carryover cost basis (which is generally lower than a market value basis). This is also part of estate planning.

13. **AVOID CERTAIN TAX TRAPS WHEN SELLING AT A GAIN** - Examples are depreciation recapture (Chapter 30-A) and dealer status (see Chapters 41 to 43).

14. **COMBINATIONS OF TAX STRATEGIES** - Some of the above strategies can be combined to reduce, defer or eliminate the taxable gain on the sale of investment real estate.

For example, a *1031 exchange* can be combined with the following strategies:

1. **Seller financing via installment sale** (See Chapter 39-B)

2. **The $250,000/$500,000 exclusions** (On our Member-Only Site, [www.GoldmineVIPAccess.com](http://www.GoldmineVIPAccess.com). Email us, with your R VIP code for the password – [isujaninepratt@aol.com](mailto:isujaninepratt@aol.com)).

3. **Loss reductions can reduce any taxable portion of a 1031 exchange** (See Chapter 34-A)

4. **Self-directed IRA’s** (See Chapter 31-A)

5. **Tax-deferred options** (See Chapters 40, 40-A, 40-B, 40-C)

6. **Involuntary conversions** (See Section VIII-26 of *The 1031 Money Machine*)
(7) **A Tax-Free, Cash-Out Refinance** (See Section VI of *The 1031 Money Machine*)

YES, a 1031 exchange can be combined with all of the above. Such combinations are *powerful* tax reduction gems!

Reference Source (return tab): **SAP 31**
# Tax-Free Power With Self-Directed IRA’s

Reference Source (return tab): **SAP 31, Part B**

In this chapter we cover the following:

<table>
<thead>
<tr>
<th>A. WHAT IS A SELF-DIRECTED IRA (SDIRA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>B. THREE MOST POWERFUL ADVANTAGES OF RETIREMENT PLANS</td>
</tr>
<tr>
<td>C. IRA’S -- PROHIBITED (SELF-DEALING) TRANSACTIONS = COSTLY PENALTIES. HOW TO AVOID THEM</td>
</tr>
<tr>
<td>D. USING AN SDIRA FOR QUICK FLIPS</td>
</tr>
<tr>
<td>E. GREAT SDIRA EXAMPLE – FLIPPING AN OPTION</td>
</tr>
<tr>
<td>F. YOU GENERALLY SHOULD NOT USE A SDIRA TO PURCHASE LEVERAGED RENTAL PROPERTY AS A KEEPER</td>
</tr>
<tr>
<td>G. YOUR SDIRA CAN PURCHASE “CASH COW” KEEPERS</td>
</tr>
<tr>
<td>H. YOUR SDIRA FOR “PAPER” INVESTMENTS FOR HIGH TAX-FREE YIELDS</td>
</tr>
<tr>
<td>I. MAKING DIRECT LOANS FROM YOUR SDIRA FOR HIGH TAX-FAVORED YIELDS</td>
</tr>
<tr>
<td>J. TAP YOUR IRA FOR A PENALTY-FREE, TAX-FREE AND PAYMENT-FREE CASH ANNUITY - AN EXAMPLE</td>
</tr>
<tr>
<td>K. LENDING MONEY TO AN ENTITY IN WHICH YOU OWN LESS THAN 50%</td>
</tr>
<tr>
<td>L. HOW FULL-TIME REAL ESTATE INVESTORS CAN CREATE EARNED INCOME</td>
</tr>
</tbody>
</table>
A. WHAT IS A SELF-DIRECTED IRA (SDIRA)

A SDIRA is an IRA (or other type of retirement plan) in which you, as opposed to some institution (such as a bank or brokerage firm), have control over your own investment. You have much more freedom and flexibility than an institutional plan. Along with a third party custodian, you initiate the investment decisions when you want. You are not just locked into the products offered by financial institutions such as banks or brokerage firms. With your own SDIRA, you have tax-free power! You can lend money for high tax-free returns. You can buy a bargain property and flip it for a quick tax-free cash profit. You can sell a property at a profit, take a down payment, finance the rest and receive it in monthly payments, all tax-free. You can also buy discounted paper and tax lien certificates for high tax-free yields. Your range of options is much broader with a gourmet variety of high-yielding investments (discussed later in this SAP). Your SDIRA can do of all these transactions (and more) free of the drain of taxes! Self-directed IRA’s are clearly permitted by tax law, IRC 408(a)(2); IRC 408(h). There are also self-directed SEP’s, SIMPLE or Qualified (Keogh) plans. Understand that a SDIRA is not another type of retirement plan, it’s just a much more profitable way of using tax-exempt retirement plans whether they be traditional IRA’s, Roth IRA’s, SEP’s, SIMPLE or Qualified plans.

B. THREE MOST POWERFUL ADVANTAGES OF RETIREMENT PLANS

ADVANTAGE 1. Most plan deductions are tax deductible. [Even if the plan deductions are not tax deductible, such as with a Roth IRA, you will have the advantages of permanent tax-free income.]. When the contributions to the
plan are currently tax deductible this generates tax dollars in your pocket, yet it's all still your money! (Just the “pockets” change.) Moreover, the deduction is allowed in addition to whether you itemize deductions or take the IRS standard deduction. A deductible retirement contribution can also drop you into a lower tax bracket as well. In most states you also get to deduct your IRA contribution from state income taxes.

You can leverage with these plans as you do not have to make the plan contribution until after the tax year. For IRA’s, you have until the following April 15th to make any IRA contributions for the prior tax year. Be alerted that beyond this April 15th date, you cannot extend any IRA contributions, even if you file tax return extensions. However, funding your IRA by April 15th should not stop you from doing an extension to file. You simply fund the IRA by April 15th and then file your extension until October 15th. (Note: Besides extending the time to make contributions, extensions have other advantages such as reducing your chances of an IRS audit and stopping you from rushing your taxes causing you to make costly mistakes).

**NOTE ON IRA CONTRIBUTIONS**: Presently the IRA contribution is 100% of earned income up to $5,000, $6,000 if age 50 or over. However, with a non-working spouse, you can contribute double these amounts ($10,000, or $12,000 if age 50 or over), provided there is at least these amounts of combined earned income (that is, $10,000, or $12,000 if age 50 or over). Note that the non-working spouse does not have to have the earned income, it can be the earned income of the working spouse provided it is these amounts or higher. These amounts could increase in the future.

Roth IRA’s have huge advantages. Contributions to a Roth IRA are not deductible, but you get the tax advantage of having funds accumulate tax-free in the IRA. That is both your original contributions and ALL earnings compound TAX-FREE. We mean tax-free and not just tax-deferred! Provided you meet the Roth qualifications (5year\age59-1/2 rules), cash withdrawals from your Roth
are never taxed. The tax savings on the accumulated earnings are permanently tax-free!

Plus, here are three other advantages of Roth’s:

(1) Unlike regular IRA’s, you do not have to start taking out mandatory distributions from a Roth IRA. (However, after the death of a Roth IRA owner, some of the minimum distribution rules that apply to traditional IRA’s also pertain to Roth IRA’s.)

(2) Unlike regular IRA’s, contributions to a Roth can be made after you reach age 70-1/2, as long as you have earned income.

(3) Like a regular IRA, you can take out under age 59-1/2 penalty-free distributions based on a number of exceptions, some of which are a life-time annuity, death, disability, first-time home-buyer expenses.

NOTE ABOUT ROTH 401(K) PLANS: There is also a “401(k)” Roth IRA where you can have a 401(k) election and contribute an additional amounts with NO income limitations. [You could be making a million dollars a year income and still do this 401(k) Roth IRA]. This is in addition to the regular Roth IRA contribution. This is a tax-free bonanza. For more info see IRS publication 590.

With a Qualified plan opened before December 31, you can make contribution-deductions after December 31 up to the due date of your return, plus extensions until October 15th of the following year, yet with a deduction for the previous tax year. But the plan must be set up before December 31 of the prior tax year.

With a SIMPLE plan opened before October 1, you can make contribution-deductions after December 31 up to the due date of your return, plus extensions
until October 15th of the following year, yet with a deduction for the previous tax year. But the plan must be set up before October 1 of the prior tax year.

**STRATEGY WITH SIMPLE PLANS:** You can deduct 100% of earned income presently up to $11,500 ($14,000 if age 50 or over). This is in addition to an IRA deduction of $5,000 ($6,000 for age 50 or over). Therefore, with a SIMPLE plan, you do not have to be paid substantial amounts of ordinary earned income subject to employment taxes. For example, $11,500 paid as a guaranteed payment from your LLC-partnership would allow you to contribute $11,500 to a Simple plan and $5,000 to an IRA or a total of $16,500 plan contributions. If age 50 or over, $14,000 paid as a guaranteed payment from your LLC-partnership would allow to contribute $14,000 to a Simple plan and $6,000 to an IRA or a total of $20,000 plan contributions. This is powerful! (A partnership **guaranteed payment** is earned income that does not require payroll filings. It is discussed further in Goldmine Chapter 5)

With a SEP plan you can open and fund the plan after December 31 until filing time plus extensions until October 15th of the following year, yet with a deduction for the prior tax year. Unlike qualified or simple plans, a SEP plan does not have to be set up in the prior tax year to get the SEP post-year contributions for the prior year deductions.

**TIP:** **Fund these plans as earlier as you can.** The more time your money accumulates in the plan the more time it is sheltered from taxes. Over time this could be quite dramatic in your wealth accumulation.

**ADVANTAGE 2. The earnings within the plan are tax-deferred and with a Roth IRA permanently tax-free.** With this second big advantage, the earnings on the already tax-deductible contributions compound tax-deferred until distributed. This includes ALL earnings, such as interest, dividends, gains, rents, royalties and resale profits (such as those from flipping properties or paper). Even better, in a Roth IRA (including the new 401(k) Roth) all of these earnings are tax-free and not just tax-deferred. That is both your original
contributions and ALL earnings compound \textit{tax-free}. So ALL of your Roth profits will become \textit{permanently} tax-free. Contrast this with a taxable savings or investment account where your income would be drained by taxes.

\textbf{ADVANTAGE 3. The tax-deferred earnings grow exponentially via the power of tax-free compounding.} 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 \textit{tax-free} compounding, earnings accumulate not only on the principal amount of money but also accumulate on the \textit{tax-free} earnings as well. ("Earnings on Earnings"). Thus compounding \textit{combines} earning power on principal \textit{and} earning power on interest. Compounding has been called the "8th wonder of the world", a "miracle". Compounding is a silent powerful wealth building force that without notice can make you wealthier & wealthier. It is a \textit{money-growing-cycle} that begins when each one of your investment dollars starts earning more dollars. Those earnings in turn join forces with invested dollars to keep repeating the money-making process. Compounding money at high rates of \textit{tax-free} return is a definite advantage of real estate, especially with a SDIRA.

[For a further discussion of retirement plans, refer to my audio CD series \textit{Power-House Tax Strategies For Self-Employed Entrepreneurs}, tape 5]

\textbf{C. IRA’S -- PROHIBITED (SELF-DEALING) TRANSACTIONS = COSTLY PENALTIES. HOW TO AVOID THEM}

\textbf{PART A. Prohibited Investments With Retirement Plans:} The following investments are \textbf{not} permitted to be acquired by retirement plan accounts: Personal-use property such as your home or a second home; collectibles including gems, stamps, coins, antiques, art works, carpets, alcoholic beverages, certain intangible property and non-U.S. coins*. *\textit{U.S. coins} are permitted and certain bullion is also permitted.
**BREAK:** As you can see, not being able to invest in these is no big deal. As all other types of investments discussed are permitted such as real estate, quick sales, rehabs, paper, options, liens, loans, etc.

**PART B. Prohibited Transactions With Retirement Plans:** Generally, a prohibited transaction is any improper use of your retirement account by you or any related disqualified person. The following are related or disqualified parties.

1) You (the IRA owner); those who make 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),

2) Also disqualified parties are entities - corporations, partnerships, LLC’s, LP’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.

*ALERT ON “CONSTRUCTIVELY”*: 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 SDIRA does with this LLC-partnership are prohibited (or self-dealing) and subject to penalties.

**TAX BREAK:** Here, related parties do not include brothers* sisters*, aunts, uncles, nieces, nephews, cousins, friends, associates and less than 50% non-constructively owned entities. Therefore your SDIRA can do business with these parties.
(*Note: For other tax law provisions brothers and sisters are considered to be related parties, but not here).

So basically a related party is an ancestor, spouse, descendent, and/or any business directly or constructively owned 50% or more by one of the above related parties.

Certain transactions (listed below) between the SDIRA and a disqualified person generally are prohibited. Some examples of prohibited transactions with a retirement account are:

(1) Borrowing money from it.
(2) Selling property to it
(3) Using it as security for a loan
(4) Receiving unreasonable compensation for managing it – DO NOT TAKE ANY COMPENSATION AT ALL FROM THE IRA
(5) Buying property for personal use (present or future) with IRA funds
(6) Prohibited investments per A above, just previously discussed.

Doing these prohibited (self-dealing) transaction will cause the IRA to be taxed as ordinary income for the amount involved and, if applicable, a 10% penalty on early distributions before age 59-1/2, IRC 72(q). The same would apply if the IRA was pledged or used as security for a loan. IRC 408(e)(3). These prohibited (self-dealing) transactions apply to traditional IRA’s, Roth IRA’s, SEP plans and Simple plans. The way to avoid them is not to do them.

Based on the above, let’s further clarify what your retirement account cannot do:

_It cannot_ buy your primary or second home. It also cannot rent the home to you.
It cannot buy, lease, or sell property (or other investments) from (or to) spouses, lineal descendants such as parents, children, grandchildren and in-laws. This includes your SDIRA making direct loans to these related disqualified persons previously mentioned.

It cannot buy, lease, or sell property (or other investments) from (or to) an entity (such as a partnership, LLC, LP or corporation) in which you directly or constructively own 50% or more. This also includes your SDIRA making direct loans to these related disqualified persons.

**ALERT:** Also, you cannot borrow from your IRA, SEP or SIMPLE plan. Moreover, your IRA, SEP or SIMPLE plan cannot be pledged or used as a security for a loan. The part secured will be treated as an ordinary taxable distribution of ordinary income included in your gross income and, if applicable, the 10% penalty on early distributions before age 59-1/2, IRC 72(q).

**TAX BREAK:** However you can borrow funds from the IRA of a person who is not disqualified (or unrelated), including brothers and sisters and others previously mentioned.

**ANOHTER BREAK:** You can borrow (within certain dollar limits) from your own qualified (Keogh) plan or use it as security for a loan, provided the plan has a provision that allows borrowing or pledging in accordance with the Internal Revenue Code and Regulations, IRC 72(p)(2).

Here are some examples of IRA transactions – prohibited or not prohibited:

- Your IRA loans you $80,000 to start a business. Is this a prohibited transaction? Yes. You are a clearly related party.

- Your IRA loans $120,000 to you and your brother's LLC-partnership of which you own 49% and your brother owns 51%. Is this prohibited? No. You own
less than 50% and your brother is not considered a related party. So you do not constructively own the other 51%. Not prohibited, here you are A-OK.

_Your IRA loans $20,000 to your nephew to start pay his college tuition. Is this a prohibited transaction? No. Your nephew is not considered a related party. Not prohibited; this is alright too.

**Penalties:** Engaging in these prohibited transactions is costly as it will cause your retirement plan assets to be taxed and possibly penalized.

**Correcting prohibited transactions:** If you participated in a prohibited transaction, you can minimize the tax by correcting it as soon possible. Correcting it means undoing it as much as you can without putting the plan in a worse financial position than if you had acted under the highest fiduciary standards.

**Tax law cites for prohibited transactions:** Internal Revenue Code Sections 4975 and 72(q). IRS Publications 560 and 590.

**D. USING AN SDIRA FOR QUICK FLIPS**

Once you avoid being a dealer (Ch 42), use the SDIRA for avoiding taxes on gains, 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, even a million dollars or more!

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. What a great college fund without costly annoying student loans that later come back to bite 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 age 59-1/2, or if under 59-1/2 because of death, disability or for first-time home-buyer expenses. Plus 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 and forever tax and penalty free!

**NOTE:** In order to use the SDIRA to defer taxes on profits, the property must have been originally acquired by the SDIRA and not by you.

Continuing on.... Selling real property quickly (or “flipping”) is essentially broken down into two major categories: (1) Wholesaling and (2) Retailing (or Rehabbing).

**(1) Wholesaling** - This is selling the property “as is” with no or very little fix-up. Many times the entrepreneur never goes to settlement and will just assign (or “flip”) the agreement of sale to their buyer for a profit.

**SDIRA STRATEGY:** Because it usually requires little or no cash, wholesaling is ideal for self-directed plans especially for beginners who are just starting to fund their plans. Wholesaling frequently only requires a modest earnest money deposit such as $100 to $1,000, even only $10 especially when dealing with motivated sellers (which is the only type of seller you should be dealing with). Accordingly, you can start an IRA (preferably a
Roth) with just $5,000 or less, and begin wholesaling to amass thousands, even millions in relatively short periods of time.

(2) Retailing (or Rehabbing) - This is selling the property after doing at least a fair amount of fixing up. Often the fixing up is substantial. Most of the time the entrepreneur goes to settlement to buy the property, does the rehabbing, goes to settlement again selling the property all fixed up.

**SDIRA STRATEGY:** Because it requires more cash, rehabbing is conventionally much more suitable for plans that already have substantial cash amounts in them (such as from wholesaling); or will use unrelated partners and in other cases non-recourse financing, where there is not personal liability (as opposed to recourse financing, where there is personal liability and which is prohibited in an IRA).

And by the way your SDIRA can also flip a straight option or master lease as discussed and illustrated in Chapters 40A and 40B.

**E. GREAT SDIRA EXAMPLE – FLIPPING AN OPTION**

Here is one that one of my students (Tim) did using his self-directed Roth IRA. Tim’s Roth IRA paid $3,500 to his unrelated roommate for an option to buy at market value a 50% interest in his highly appreciating rental home in Hawaii sometime in the next 10 years. The option was recorded with the county in Hawaii (good move on Tim’s part!). At the time the house was valued at $700,000. The roommate then received an offer from his tenant living in the house to buy the property. The roommate was tired of long-distance landlordling (a motivated seller), so he accepted the offer (and did a 1031 tax-free exchange on his end; smart move). Since my student’s Roth IRA’s option clouded the title, he agreed to pay my student’s Roth IRA a cancellation fee of $35,000 (which is 10% of the current $350,000 value of Tim’s one-half interest in the $700,000 property). The $35,000 option fee is tax-free in the Roth and a 10-fold increase in the Roth’s original investment of $3500.
COMMENTARY: What a beautiful transaction! Of course, his idiot accountant did not agree. Get ready to laugh at what this numbskull said (it never ends with these guys). That this would not pass IRS scrutiny as the original option agreement would be viewed as not making sound business sense and the IRS would view the transaction as a “conspiracy” to fund Tim’s IRA with the cancellation fee paid to the Roth. First off, this is an arm’s length transaction between two unrelated parties, one motivated to buy and the other motivated to sell. Second, an option is a permitted investment in a retirement plan (including a Roth), IRC 408; IRS pub. 590. Third, while there may be a limit on the IRA contribution, there is no law limiting the amount of profit in an IRA. Accordingly, all of this makes sound business sense and it is not the absurdity of being a conspiracy. A while back when the dot.com stocks were going up through the roof, which could have been in one’s IRA, was that a conspiracy? Of course not; huge profits are made every day and are not a conspiracy! Not that there is anything illegal here, there is not, as the above is perfectly legal. Most of all, Tim’s accountant is an imbecile 10 fold over. Sorry to sound harsh here, but this kind of egregiously, incorrect, costly advice must STOP. It’s costing investors (like you) tens of thousands of dollars every year. If you don’t know your stuff, get the hell out of the tax advisory business or at least recommend a specialist!

F. 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 via componentizing. 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 (outside the SDIRA) including creating NOL’s. You would end up losing thousands of savings.
**STRATEGY:** When you sell the keeper, you can *zero out* taxes on the gain via a 1031 exchange, or a number of other ways that we discuss in the *Renaissance Goldmine*.

Moreover, if your IRA purchases real estate with a recourse mortgage (where you are personally liable), there are costly penalties. If the property is purchased with a non-recourse mortgage (where you are not personally liable), there are less adverse consequences (if any), but it still does not make “tax” sense as per the above. Also 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.

And your SDIRA should avoid any other investment that is tax-exempt, tax-deferred, or that allows you write-offs to reduce your income from the investment down to zero; or less than zero as a tax-deductible loss which loss will yield no benefit in an IRA.

**G. 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 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.
**EXAMPLE:** You acquire a bargain property for $40,000 which includes cost plus improvements. You pay all cash for the property. Taxes, insurance and other operating expenses are $3,000 a year. You obtain a tenant for $800 a month or $9,600 a year, leaving you with a positive cash flow of $6,600. Assume tax depreciation allowed would be $1600 a year. Your after-taxable net income on the property is $5,000 ($6,600 less depreciation of $1600). In a 30% tax bracket, you would have to pay $1,500 in taxes on the $5,000. If you owned 10 of these properties or it was a 10 unit multi-family (many investors own much more), you would have to pay 10 times this amount in taxes or a total of $15,000. With a SDIRA you avoid paying taxes on all of this income so the cash flow is tax-free.

**NOTE:** If your SDIRA sells the property at a profit, then all of the gain is tax-free. Remember, ALL income (rents, gains, etc.) are tax-free within a retirement plan. This tax-favored bonanza continues with the SDIRA.

**STRATEGY:** You should still take depreciation on these cash cows held by your SDIRA. *Reasons:* First off taking depreciation is mandatory on depreciable assets such as rental property. Therefore, doing so is proper tax compliance which is something you especially want to do with your SDIRA.

[Note: To keep things simpler, you do not have to take component depreciation; you could use the conventional method, 27-1/2 years for residential rental property or 39 years for commercial property].

**AVOIDING DEALER STATUS:** But a more important reason is that not to claim depreciation, could be construed as an admission of dealer status, especially if the property were quickly sold. (You should take depreciation even for such short holding periods). As inventory, dealer property is not depreciable. However, property held for “investment” is. The gain on the sale of dealer property is active business income which would be unrelated income in a retirement account and would be subject to the hefty unrelated business income tax (UBIT).
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. But your SDIRA can partner with a qualified unrelated party, or their SDIRA; or use non-recourse financing. *Unrelated/qualified and related/disqualified parties were previously defined in this SAP.*

**H. YOUR SDIRA FOR “PAPER” INVESTMENTS FOR HIGH TAX-FREE YIELDS**

What is paper? “Paper” is a note, mortgage, trust deeds, lien, accounts receivable or some type of paper instrument, usually debt, where you could get a yield or profit for your investment. Some types of paper are real estate backed investments, such as mortgages or tax lien certificates. Paper, such as mortgages, can be in first or subordinate junior positions. In a SDIRA the yield or profit from paper will be higher because the yield will be tax-free. The types of paper that your SDIRA can invest in are:

Those that are real estate related paper such as:

- Privately-held mortgages (preferably “discounted mortgagees”)
- Tax lien certificates (TLC’s)
- Judgments/liens
- Partial interests in real estate

Those that are *not* real estate related paper such as:
Structured settlements

Accounts receivable

Equipment leases

Automobile paper

Partial interests in on-going businesses.

These are topics unto their own that call for specialized knowledge and therefore will not be discussed here.

I. MAKING DIRECT LOANS FROM YOUR SDIRA FOR HIGH TAX-FAVORED YIELDS

Once you accumulate funds in your IRA from flipping properties, you can have enough cash in your IRA to be a tax-free lender. Your SDIRA can directly lend money secured by a mortgage on real estate. The people who borrow that money from you pay you interest which is the yield on your investment. Typical yields can range anywhere from, on an average, 10% to 18% and even higher, plus any points. You need to check the usury laws of your state.

TIP 1: DO YOUR HOMEWORK BEFORE MAKING DIRECT LOANS! The responsibility of collecting on defaulted loans is yours (not the IRA trustee). Safety with your SDIRA should be an important concern. You should very carefully qualify the borrower. The lower the loan-to-value, the safer the loan, such as 60% or lower. There should be proper securing of property as collateral along with the correct identification of the borrower as the rightful owner of the secured property.

TIP 2: Always keep back-up liquid reserves in your SDIRA to pay for legal expenses in the event of default by the debtor.
TIP 3: Check your state’s banking laws; state and federal Security & Exchange Commission (SEC) regulations; or any other legal requirements to be a direct lender.

J. TAP YOUR IRA FOR A PENALTY-FREE, TAX-FREE AND PAYMENT-FREE CASH ANNUITY - AN EXAMPLE

One of the ways you can receive IRA funds without incurring penalty (even if you are younger than age 59-1/2), is to receive a life-time annuity schedule of essentially equal payments. But here is a way to tap your plan for not only a penalty-free annuity, but also one that is income tax-free and payment-free. This is done by obtaining a home-equity loan with a loan payment going out about the same as the IRA annuity coming in. Here, you will have two very positive offsets:

1. A “cash” offset, where your loan payment going out is offset by your IRA annuity coming in.

2. A “tax” offset, where the deductible interest from your home-equity loan payment offsets your taxable IRA annuity payment.

EXAMPLE: After determining the amount of annuity payments you can receive, you take out a home equity loan at the same amount of payments. Assume you can take out $500 a month as an IRA annuity and that $500 a month will enable you to obtain a home equity loan of $50,000. The $500 IRA annuity offsets your $500 loan payment, while the loan interest offsets your taxable IRA annuity.

Result: A lump sum of penalty-free, tax-free & payment-free cash of $50,000, which you can invest and earn more income!
Assume you invest the $50,000 in real estate at an annual yield of 20% per year or $10,000 a year annual income which is totally sheltered by property componentizing deductions and is therefore tax-free!

Result: You used your IRA annuity, in a tax-favored manner, to generate another $10,000 tax-free income, every year...plus the equity build-up in the property!!

Money makes money, but tax-free money makes a whole lot more money!

K. LENDING MONEY TO AN ENTITY IN WHICH YOU OWN LESS THAN 50%

You can lend to an entity, such as a partnership, LLC or corporation in which you own less than 50% (49% or less), and the remaining interest is owned by unrelated parties. IRC 4975 (e)(2); IRS Pub. 590.

EXAMPLE - Lending money to an entity in which you own less than 50%:
You are a 49% partner in the AB LLC partnership, which invests in real estate, tax lien certificates and discounted mortgages. The other 51% partner is your brother who is not considered a related party for the purpose of the rules regarding prohibited transactions discussed in C of this chapter. The partnership is averaging a 30% return on their investments, but has run out of funds to invest. Your SDIRA lends AB $50,000 at 15% annual interest.

Again, we have a win-win. AB pays 15%, but doubles it at 30%. Your SDIRA gets an excellent return of 15%, plus, as a 49% partner of the AB LLC-partnership, you can deduct 49% of the interest, yet the receipt of the interest is tax-free in your SDIRA. It’s a win, win!

L. HOW FULL-TIME REAL ESTATE INVESTORS CAN CREATE EARNED INCOME ELIGIBLE FOR MORE PLAN CONTRIBUTIONS & DEDUCTIONS
For many real estate investors (especially full-time), their sole source of income is rents, investment gains, interest, dividends and perhaps retirement benefits from a former employer. However, this type of passive income is not “earned income” and thus does not qualify for retirement plan contributions to IRA and SEP, SIMPLE or Qualified plans. Sometimes the only earned income they have is W-2 income from a regular job with an outside company. W-2 income from an outside job qualifies for an IRA. But because it is not self-employment income (it’s not your own business), it does not qualify for additional contributions to a self-employment plan such as a SEP, SIMPLE or Qualified plan. They are additional sources of retirement plan deductions along with tax-free compounding.

Essentially there are three ways for such real estate investors to create earned income (or additional earned income) eligible for plan contributions, listed in the order of preference:

1. **Generate Earned Income From A Partnership (“Guaranteed Payment”)**

2. **Generate Earned Income From Another Business**

3. **Form Your Own Separate Management Company**

1. **Generate Earned Income From A Partnership (“Guaranteed Payment”)**
   - For most real estate investors this will be the simplest most effective way. First off, as recommended in Goldmine Chapters 4 and 5, investment real estate should be held in a partnership and for asset protection in an LLC with two or more member-partners.

   Even though the real estate partnership is generating passive income, such as from rents and/or investment property gains, the partnership can pay out earned income to its partners. Even if the partnerships is generating losses, the partnership can still pay out earned income to its partners, IRC 1401(a)(1);
Regulation 1.1402(a)-4. Such earned income is created by the partnership paying you (and/or the other partners) a “neat” thing called a guaranteed payment which is a payment that is made without regard to partnership income. Such payment is ordinary earned income to the recipient-partner*, IRC 707(c); IRC 61(a). But on the other hand the payment is deductible by the partnership, IRC 162(a); IRC 707(c). So income-tax wise, it’s essentially a wash. (*Note: In an LLC-partnership, the members are the partners.)

To be a guaranteed payment it should not be based on partnership income or a percentage of partnership income, Reg. 1.707-1(c). It should be in the form of a straight fee* for specific services rendered by the partner to the partnership in their capacity of a partner without regard to partnership income. Examples of such services could be accounting, bookkeeping, management, maintenance, contract work, marketing, consulting, etc. (*The straight fee is like a 1099 payment yet without the need to file a 1099).

The guaranteed payment to the partner is self-employment earned income subject to social security taxes (Internal Revenue Code Sections 1401 through 1403). It is not paid as a salary via a W-2. Thus, payroll reports do not have to be filed. Taxes on the income must be paid by the partner on their 1040. But the guaranteed payment is the basis for valuable retirement plan contributions to IRA’s as well as to SEP, SIMPLE or Qualified plans. The individual partner reports the guaranteed payment as “other income” on page 1 of their individual 1040 and such income is subject to income taxes (but remember it’s deductible by the partnership). If the individual partner is under the social security base amount, they must also report the guaranteed payment on IRS Schedule SE and pay the applicable social security taxes. If the individual partner is over the social security base amount they still must pay the Medicare tax.

However, while the partner is paying Social Security taxes, or just Medicare taxes, or both employment taxes; this guaranteed payment is earned income and again the basis for valuable retirement plan contributions to IRA’s as well as to SEP, SIMPLE or Qualified plans. The guaranteed payment arrangement should
also be incorporated in the partnership LLC operating agreement. (By the way, guaranteed payments are optional and not required as with corporate salaries. What a winner!)

2. Generate Earned Income From Another Business - Another way real estate investors can create earned income eligible for plan contributions is by being self-employed with a side-line or home-based business. For example, a number of veteran investors also earn income by doing consulting or mentoring for beginning investors. Others become involved in multi-level marketing products or services (such as Pre-Paid Legal Services www.prepaidlegal.com/hub/janinepratt), while others earn real estate commissions by having a real estate license. Some of my students earn income from their own 1031 exchange intermediary company using my Turbo-Exchange program. And there are many other such home-based businesses you can engage in, provided that it meets your non-tax economic goals as well.

TAX ADVISORY ON EARNED INCOME: For self-employed sole proprietors and partners, earned income is net income from self-employment, which is gross income less business expenses (such as the net income from Schedule C). If your business is operated by a corporation, then the earned income is paid to you as a W-2 salary because you are an employee of the corporation. Here, your gross salary is the earned income.

EXAMPLE – Sole proprietor: Mary is a full time real estate investor who has a lot of contacts and also has a real estate license. As a licensed agent and because of her contacts, she earns most of her commissions by just referring real estate investors to other real estate agents. For the year she earns $30,000 in gross commissions with related business expenses of $20,000 and a resultant net income of $10,000 on her Schedule C. Mary’s earned income eligible for plan contributions is the net income of $10,000. Based on the $10,000 of earned income, Mary can contribute $10,000 to a SIMPLE plan and $5,000 to an IRA for a total of $15,000. If she is age 50 or over, she can contribute even
higher amounts. (See Part 2 of this chapter for more Simple Plan examples with even higher contribution amounts).

**Two more sources of earned income for plan contributions:**

1. *Taxable Alimony.* A divorced spouse with little or no earnings may treat taxable alimony as compensation, giving a basis for deductible IRA contributions. He or she may make an IRA contribution equal to 100% of taxable alimony up to the IRA contribution limit.

2. *Non-Working Spouse.* Provided you have enough earned income, if you have a nonworking spouse under age 70-1/2, you may contribute up to the IRA contribution limit to his or her IRA. This is so even though no contribution may be made to your own traditional IRA because you have reached age 70-1/2. (But with a Roth IRA, you can continue to make contributions even if you are past age 70-1/2).

**3. Form Your Own Separate Management Company** - The net fees of a management company are earned income and eligible for plan contributions. From the rent income of your properties (which is not earned income), you pay to the management company a fee (which is earned income) for various services the management company performs such as collecting rents, selecting or evicting tenants, property accounting, etc.

**TAX ALERT ON USING A MANAGEMENT COMPANY -- PASSIVE LOSS LIMITATIONS:** If you are claiming losses from your rental properties, this separate management company must not incur too many hours in order to bypass passive loss limitations under Internal Revenue Code Section 469. *Reason:* In order to bypass the IRS passive loss limits and deduct property losses against your other income, you or your spouse must perform a certain amount of management functions, especially landlord-tenant activities. These functions must be performed by you or your spouse (or as a member-manager
of the entity that owns the properties, such as an LLC), and not another company, even if it’s your management company.

Remember, the management company (such as a corporation) is a separate, distinct entity apart from you and your spouse. Thus, the management company’s performance of these activities is not attributable to you or your spouse. (For a further discussion of the above, with tax law references, refer to Chapter 5-B.)

Because it entails using another entity and may cause passive loss limitations as per the above, using your own management company is the least desirable way to generate earned income and is generally not recommended.

**M. SDIRA’S–LLC’S**

There are also IRA – LLC’s with checkbook control, but these must be set up properly, otherwise there can be prohibited self-dealing issues. Email us for an expert on LLC-IRA’s with your Renaissance VIP code – taxbible@aol.com.

The above was just an overview of a more comprehensive topic, but certainly enough to understand their wealth-building power.

Reference Source (return tab): **SAP 31, Part B**

---

**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious
copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under **BOTH** civil and **criminal** law.
Using The 1031 Exchange To Zero Out Taxes On The Sale Of Your Property

A. WHAT IS A 1031 EXCHANGE?

Briefly stated, a 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 (discussed in the next chapter). So there are at least two closings (settlements) where you are selling on one end and buying on the other end.

One of the biggest misconceptions about exchanges is that they are “pure” exchanges or 2-way barter. This is generally not so. Here is what typically happens:

⇒ At the first settlement you sell your relinquished property to “Joe Buyer”
⇒ At the second settlement you will acquire the replacement property from another person, let’s say, “Mary Seller”
⇒ Joe Buyer and Mary Seller will have nothing to do with the exchange
⇒ The above settlements must be performed within 180 days of each other in a forward exchange
⇒ Under specified IRS regulations
⇒ Including using a Qualified Intermediary (discussed in the next chapter).

B. WHY EXCHANGES BUILD WEALTH

1. A 1031 exchange can save you a significant amount of taxes - Without the tax-free benefits of Section 1031, the investment property owner would have to pay taxes on the realized gain which is the difference between the net selling
price and adjusted tax basis of the property. With rental and commercial properties, there are several factors that can substantiality (and quickly) increase your taxable gain. Some of these are:

a. Appreciation (even modest appreciation over time).

b. Accumulated depreciation write-offs reduce the tax basis of your property which has the same effect as appreciation -- increase gain.

c. Any prior deferred gain from another rollover reduces basis and increases gain.

Therefore, even without appreciation it is still possible to have a sizable taxable gain, because of non-cash taxable adjustments such as numbers 2 & 3 above.

With a 1031, you can zero out all of the multiple tax liabilities that were covered in Chapters 29 and 30 - Capital gain taxes, recapture taxes, alternative minimum taxes, additional taxes from an increase in AGI, state and local taxes.

2. With a 1031 exchange you have the opportunity to invest the deferred taxes to accumulate income where the tax savings could be permanent and not just deferred - Technically, when a property is rolled over via 1031 the untaxed gain does not go away but stays with each rollover and would become taxed if the property were sold in a taxable disposition. This is why the untaxed gain is called a "deferred gain". But when you invest the deferred tax savings in the replacement property, and assuming this property generates a 20% return, you will get your deferred tax savings back in 3-1/2 years; if a 30% return (very common), then you will get your deferred tax savings back in 2-1/2 years. At the point when you get back your deferred taxes, your 1031 is no longer tax-deferred, it’s tax-free. And after that point it’s all incremental wealth! Plus, "Defer, Defer, Defer - Die!" That is by continuing to rollover property until death, the gain is no longer deferred but permanently eliminated. This is because under the tax law the death of the property owner will effectively cause
an elimination of the taxable gain by a "step-up" of the tax basis to the fair market value of the property (IRC 1014). As a result of employing section 1031, your heirs will have a much larger estate not only from the taxes saved but also from the years of compounded earnings on these taxes saved.

3. **With a 1031 exchange you have a variety of reinvestment options** - One of the requirements for a qualifying 1031 rollover is that the properties must be “like-kind”. However, the term "like-kind" is not nearly as narrow as it sounds. 1031 rollovers apply to a *diversity* of small, large, residential rental, commercial, industrial, rural, resort-area or any combination of such investment properties. Examples are: rental houses, condos, vacation (rental) homes, duplexes, apartment buildings, land, marinas, trailer or mobile home parks, shopping centers, retail stores, office buildings, motels, hotels, B&B’s, parking lots, golf courses, quarries, ranches, farms, garages, warehouses, plants, factories, storage facilities...even... ground leases and easements. Even raw land can be rolled over into cash-producing rental property (or vice versa). *Several* properties can be disposed of, or acquired via a 1031 exchange. There is a gourmet variety of diversified options.

4. **By rolling over tax-free into superior property, you can more easily accomplish goals** - Increase capital appreciation; increase cash flow; consolidate smaller properties into a larger one; diversify a larger property into smaller ones; discover that dream vacation home; relocate closer to your family; accumulate more for children's education; move closer to retirement; conserve your estate; relieve yourself of day-to-day management; any combination of the above.

For more about wealth accumulation with 1031 exchanges, refer to my *1031 Money Machine*. 
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
IRS Requirements For 1031 Exchanges

To have a qualifying exchange ALL of the following requirements must be met:

REG 1. QUALIFIED INTERMEDIARY (“QI”)
REG 2. QUALIFIED ESCROW ACCOUNT
REG 3. BOTH THE QI AND ESCROW AGENT MUST BE “QUALIFIED”
REG 4. THE CORRECT DOCUMENTATION MUST BE USED
REG 5. TWO TIME REQUIREMENTS, 45 & 180 DAYS
REG 6. “LIKE-KIND”
REG 7. HELD FOR INVESTMENT OR BUSINESS USE

Requirement 1: QUALIFIED INTERMEDIARY (“QI”) - The IRS requires that ALL exchanges (delayed and simultaneous) use an independent, unrelated “qualified intermediary”, IRS Regulations 1031(k)-1(g)(4) and 1031(b)-(2).

(1) What is a QI. The QI is a “middleman” that will acquire and transfer the relinquished and replacement properties to create the “exchange”. These acquisitions and transfers are generally accomplished by exchange documents and not by additional deeds. In other words, there is no need for additional deed transfers (in most exchanges). Just the usual types of deeds
can be prepared as you would with any other settlement. In fact the QI does not even have to be at settlement.

(2) **A QI is required on All 1031’s.** The QI is a “safe harbor” in the IRS regulations. This safe harbor function is typically done by a private service company that is retained by the property owner doing the exchange. The QI prepares the necessary documentation and forms to create the “exchange” so that it qualifies under IRS regulations. At the present time there is no licensing requirements for QI’s and most title agencies are not QI’s.

(3) **Fees.** The fees of QI’s vary. Generally, in comparison to the wealth accumulation benefits of 1031’s they are extremely reasonable. For example, for a residential exchange a typical fee may be a $1000 to $1500. Let’s say a fee of $1500 to save taxes of $15,000 equates to a **1000% return!** The fees for commercial exchanges would be higher but the results even are more staggering.

(4) **A “limited service” QI** will only prepare the documentation and act as escrow for the 1031 exchange. They will not help you to structure your exchange. They do not advise you on the tax law or accounting aspects of your exchange.

(5) **A “full service” QI** does exchanges *full time* and will not only prepare the essential documents, but also will counsel and guide you on all of the technical aspects of your 1031 rollover. This is an important part of the service because most tax professionals are not 1031 Exchange Specialists.

**RECOMENDATION:** You should engage a full service QI who will be readily available to render you technical advice throughout your 1031. Moreover, you should engage the QI well in advance of any closings. For high quality QI’s see the end of this chapter.
Requirement 2: “QUALIFIED ESCROW ACCOUNT” –
(1) The qualified escrow account is also a “safe harbor” in the IRS regulations. IRS Regulations 1031(k)-1(g)(3). When you settle on your property you must not receive the sales proceeds - such funds must be held in a “qualified escrow account” (with a qualified escrow agent) for the purpose of acquiring replacement property. The 1031 escrow is required in a delayed* exchange.

*NOTE: Simultaneous exchange closings (of the relinquished and replacement properties) will generally not require escrow, but do require a qualified intermediary. Reg. 1.1031(b)-2.

(2) Can be a separate company from the QI. The escrow agent can be a company separate from the intermediary (QI) such as a local title company or bank, or it can be the QI.

NOTE: “Escrow” and “Intermediary” are two separate safe harbors. “Escrow” holds the net sales proceeds from the closing of the relinquished property. “Intermediary” acts as middleman creating the “exchange” with the proper documentation. Both functions can be done by two separate companies or by one company.

(3) NO actual or constructive receipt. Once the funds are in the escrow account, you must not have the actual or constructive right to receive such funds. {IRS regulation 1.1031(k)-1(g)(6)}. The account must be in the name and ID number of the escrow agent. The escrow account can only pay for expenditures related to the acquisition of replacement property such as earnest money deposits, commissions, closing costs and the funds needed at settlement for the replacement property. It cannot make distributions directly to the exchangor or it cannot pay for personal expenses of the exchangor.
(4) **NOT security for a loan.** The escrow account cannot be used as security or collateral for a loan. However it *can be* used as an asset on a financial statement or mortgage application.

(5) **OK to keep escrow interest provided it is also restricted.** You can keep any interest on the escrowed funds provided it is restricted in the same manner as the corpus.

**ALERT:** The company that holds the funds should be bonded, insured, funded and have a well established, pristine reputation. They should also be a duly authorized corporation or LLC where there is *continuity of life* and the incapacity of an officer, shareholder or member will not erase the company’s existence, which in turn could cause the disqualification of the 1031 and the loss of your escrowed funds. Carefully check them out, and ask for references.

**Requirement 3:** BOTH THE QI AND ESCROW AGENT MUST BE “QUALIFIED” - *Qualified* means that the intermediary and the escrow agent cannot be "agents" of you, the exchangor. Such agents (or “disqualified persons”) would be you, your employee, attorney, accountant, mortgage banker, real estate agent or broker. Included here are certain related parties - lineal descendants [under IRC 267(b)] such as parents, grandparents, children, brothers, sisters as well as more than 10% entities that you own (such as a corporation, LLC or partnership, IRC 707(b)]). All of these are known as "disqualified persons" and if you use them for your QI or escrow agent, your exchange will be disqualified. {IRS regulation 1.1031(k)-1(g)(4) & (k)-1(k)}. The QI and escrow agents must be *independent & unrelated* parties.

**NOTE:** While the QI is not allowed to act as your accountant, attorney, etc., they are permitted to render 1031 tax advice related to your exchange. This is why it is important to use a full service QI who does render such advice.
A title company can be the escrow agent holding the funds from the settlement of the relinquished property

**ALERT:** Provided that you, your employee, your attorney, accountant, mortgage banker, Realtor or any lineal descendants do not own more than 10% of the company, then the title company can be the escrow agent (provided these same rules are met).

**CAUTION! TRUE STORY:** Years ago, when I did have my own QI company, the client’s attorney suggested that we use the title company doing the closings to escrow the funds from the closing of the relinquished property. But, through our 1031 Pre-planning Diagnostic Questionnaire, I knew that the attorney also owned the title company. Because the attorney was "agent" to the exchangor and owned more than 10% of the title company, the title company could not be the escrow agent (or the QI), even though this was the first time the attorney represented the client. The attorney was representing them as legal advisor, not as a 1031 consultant. As a solution we used another unrelated title company as escrow agent. We then had a qualifying 1031.

**1031 TIP:** Again, make certain that you use a full service intermediary company that thoroughly knows 1031 rollovers and does a pre-planning review to ensure compliance to the IRS regulations. Engage the QI well in advance of any closings, even before you have a buyer. Do it right!

**Requirement 4: THE CORRECT DOCUMENTATION MUST BE USED**
- Such documentation should contain the "magic language" that conforms to current IRS regulations. The QI will prepare the documents, the most important being the following: 1031 Exchange Agreement, 1031 Exchange Escrow Agreement, 1031 Exchange Addendums and Assignments - Relinquished and
Replacement Properties, 45-Day Identification Letter, 1031 Exchange
Settlement sheets - Relinquished and Replacement Properties. For a further
discussion of these documents refer to my home study course, Turbo-Exchange.

OTHER ESSENTIAL DOCUMENTS (not usually prepared by the QI):

IRS REPORTING FORM 1099S: On form 1099S is a box for the insertion of
what is called the “gross proceeds”. In a 1031 exchange transaction the
amount inserted here should be zero (“0”). The box at the bottom should also
be checked that the transferor (the exchangor) will “receive property or
services as part of the consideration” (as this is a 1031 exchange). The
exchangor’s name and federal ID number are also to be inserted. If the QI is a
corporation or LLC (which they should be), then the QI does not receive a
1099. The 1099S is generally prepared by the title company or closing
attorney for the relinquished property.

IRS INCOME TAX REPORTING FORMS* - Forms 8824, 4797, Schedule
D. These are generally prepared by the exchangor’s tax advisor.

*ALERT: These are the only forms that are sent to the IRS. Thus, their
proper preparation requires consummate tax expertise with careful attention
to details for audit-proofing. Most CPA’s do not know how to prepare them
properly. Moreover IRS instructions are very confusing and misleading. If
you need an expert email us or see the end of this chapter.

Requirement 5: TWO TIME REQUIREMENTS, 45 & 180 DAYS -
Starting from the first closing of your relinquished property, you must adhere to
two sets of time requirements that run concurrently:

(1) 45 days to identify replacement property (see below)

(2) 180 days to close on identified replacement property.
Both run parallel from the closing date of the relinquished property; both must be met for a qualifying exchange. IRC 1031(a)(3); Reg. 1-1031(k)-1(b)(2).
(The 45 days comes out of the 180 days). There are NO statutory extensions to these deadlines (except for reverse exchanges; see later in this chapter).

**1031 TIP:** If the settlement date of your relinquished property is between October 15 and December 31, you may have to file for an extension of your tax return to have the full 180 days. File any extensions correctly and timely.

**ALERT 1:** It is the shorter of 180 days or the due date (including extensions) of the taxpayer’s tax return.[Regulation 1.1031(k)-1(b)(2)(ii)].
For example, an individual taxpayer closes on their relinquished property December 18. From this date, 180 days is June 16 of the following year. However, the taxpayer only has until April 15 of that same following year to acquire identified replacement property, unless they file a 4-month extension by April 15 (with the 1040). In one case, the taxpayer filed their tax return by the April 15th due date (no extension), but acquired replacement property after that due date. Even though the property was acquired before the 180 day time limit, the exchange did not qualify because an extension was not filed. *(O.E. Christensen, TC memo 1996-254).* **COSTING THEM THOUSANDS BECAUSE OF SIMPLE THING AS NOT FILING AN EXTENSION!**

**File the extension!** For your 1040, and if applicable file an extension for the entity that did the exchange such as a partnership or LLC. Extensions have other benefits as well; see Ch. 2 for how to file extensions.

**ALERT 2:** The number of days in each period is not extended if the last day of the period falls on a Saturday, Sunday or legal holiday. You must report the 45-day and 180-day dates when you file your tax return on IRS form 8824.
THE 45-DAY IDENTIFICATION OF REPLACEMENT PROPERTIES

a) The ID Is done by the exchangor sending a letter to the Q.I. listing the specific addresses of the identified replacement properties and by *signing* the letter.

b) The letter can be mailed, faxed, emailed or delivered to the Q.I. and is to be postmarked no later than **midnight of the 45th day** following the closing of the relinquished property. You should obtain *proof* of sending (e.g. - Fed Ex receipt).

c) Limitation as to the number of replacement properties - You can identify up to 3 properties regardless of their value with no problem. Depending on the sales price of the relinquished property it is possible to go *above* 3 properties under a special rule known as the **“200% rule”** (see the next page).

d) You do not have to be obligated to acquire all 3 replacement properties but you **must** acquire at least one of them within the 180-day exchange period. For example, In a letter to the Q.I., Ms. Investor timely identifies properties A, B, and C and ends up acquiring property F..... the “F” stands for Flunk! She does not qualify for the 1031 because she did not acquire A, B, or C.

e) TWO EXCEPTIONS TO (d) ABOVE:

1. Any replacement property closed on within the 45 days is deemed to be *automatically identified*. In the above example, if “F” were closed on within the 45 days then it would have qualified for the 1031 rollover.

2. Revocation - You can revoke prior identifications. It must be done in writing to the Q.I. and **within the same 45 days**. In the above example, if A or B or C were timely revoked and replaced with F then it would have qualified for the 1031.
IDENTIFYING MORE THAN 3 PROPERTIES (200% VALUE RULE):

Within the 45 days, you can identify more than 3 properties, but their combined fair market value must not exceed double (200%) of the selling price (fair market value) of your relinquished property (the property you are selling via the exchange).

**EXAMPLE**: If the selling price of your relinquished property is $100,000, then 200% or double this amount is $200,000. If you identify 3 properties (A, B & C) whose combined value is $400,000, you are OK because you only identified 3 properties. (Under the 3-property rule where values are not relevant). However, had you identified 4 properties (A, B, C & F) whose combined value is $400,000, then you would not qualify for the exchange, because you flunk the 3-property rule (you are over 3 properties) and you flunk the 200% rule (at $400,000 you are over $200,000 which is 200% of the selling price of your relinquished property).

**ALERT**: Although the regulations are not a 100% clear on this, it would appear safe (and prudent) to assume that each separately deeded property is a single parcel for purposes of these rules. For example, Condo A and Condo B are right next door to each other and they are separately deeded. They still are two separate properties. The same would appear to hold true for two separately deeded adjoining parcels of land*.

[*PLANNING*: If the same owner owns both parcels, you may be able to have your real estate attorney do an assemblage and merge the two deeds into one. Now you have two parcels, but one property for the purposes of the 45 ID].

**RECOMMENDATION**: Because values can be arbitrary, you generally should try to stay within the 3-property rule.
STRATEGY TO BYPASS 45/180 DEADLINES – A REVERSE EXCHANGE: A way to bypass the 45 and 180 day deadlines (and have much longer) is to properly do a “Reverse-Starker” exchange where the replacement property is acquired first, before the closing of the relinquished property, via a certain set of rules and procedures. For a further discussion refer to *The1031 Money Machine*; or with your Renaissance VIP code email us for an expert with reverse exchanges.

**Requirement 6: “LIKE-KIND”** - Both the relinquished and replacement properties must be "like-kind". This is generally a very broad category with many diverse options. Just about any type of rental, business-use or investment real estate would qualify. IRC 1031(a)(1), Regulation 1.1031(a)-l(b) and Regulation 1.1031(a)-l(c).

**A. EXAMPLES OF LIKE-KIND REAL ESTATE CATEGORIES:**

- In the *Residential Sector* - Rental houses, rental condos, rental coops, duplexes, triplexes, quadruplexes, apartment buildings.

- In the *Commercial Sector* - Shopping centers, retail stores, office buildings, motels, hotels, B&B’s, parking lots, ranches, farms, trailer parks, storage facilities, garages.

- In the *Industrial Sector* - Warehouses, plants, factories, storage facilities, etc.

Plus any other type of *Rental, Business-Use or Investment* real estate, considered to be *real* property under local law:

A. *Rental property* would be residential, commercial or industrial property that you rent out to others.
B. **Business-use property** is property you would own and use in your own business, such as an office building for your own consulting company or a plant for your manufacturing operation.

C. **Investment real estate** is property you hold for passive appreciation such as raw land (YES, land also qualifies, IRS Reg. 1.1031(a)-1(b)(c); Rev Ruling 72-515).

**Even the following qualify for like-kind:**

1. A lease of 30 years or more [Reg. 1.1031(a)-1(c)]
2. A ground lease [Reg. 1.1031(a)-1(c)]
3. A partial tenant-in-common interest in real property  [IRS Revenue Ruling 73-476 (but not a partnership interest, see later in this chapter).
4. Easements; Mineral & water rights [IRS Revenue Ruling 72-549].
5. Improvements to be constructed [Reg. 1.1031(k)-1(e)]
6. Certain time shares [IRC 1031(a)(1)]
7. Certain intangible property (but not goodwill; see bottom of next page).

**You can go round-round, get around!** Via a 1031 exchange you can "rollover" the above types of like-kind real estate any which way you want:

⇒ From *residential* to *commercial* or vice versa
⇒ From *residential* to *industrial* or vice versa
⇒ From *commercial* to *industrial* or vice versa
⇒ You can rollover a *rental house* into an *office building* or vice versa.
⇒ You can rollover a *rental condo* into a *shopping center* or vice versa.
⇒ You can rollover a *shopping center* into an *apartment building* or vice versa.
⇒ You can rollover *farm land* into a *rental house* or vice versa.
⇒ You can rollover *commercial business-use* property into *land* or vice versa
⇒ You can rollover *land* into *income producing rental* property or vice versa
⇒ You can rollover a *30-year lease* into *income producing rental* property or vs.
⇒ You can rollover an *easement* into *income producing rental* property.
⇒ You can rollover an *apartment building* into *ground leases* or vice versa
⇒ You can rollover a *part tenant-in-common interest* into a *full fee simple ownership* or vs.
⇒ You can rollover *commercial business-use* property into *residential rental* property or vs.
⇒ You can rollover *several* properties into *one* property or vs. You are not limited to just one property. Several properties can be exchanged in a 1031 transaction.
⇒ You can rollover to and from any one of these types of properties in *any location within the U.S.*

**B. RELATED PARTY RULES PERTAINING TO LIKE-KIND:**
Exchanges between *certain related parties* under IRC 267(b), where the replacement property is subsequently disposed of *before* the end of 2 years, the property is not like-kind, IRC 1031(f). But if the property is held for 2 years then it is like-kind. Thus you can do an exchange with a related party [IRC 267(b)], if the 2-year holding rule is met.

**C. PROPERTY CLEARLY NOT LIKE-KIND:** Under IRC 1031(a)(2) the following are NOT like-kind and therefore would not qualify for a 1031 rollover:

1. Bonds, securities, REITS, notes, mortgages
2. Certificates of trust or beneficial interests
3. Inventory or other property held primarily for sale (see holding requirement, next)
4. Corporate stock, IRC 1031(a)(2)(B) - Shares of stock in a corporation will not qualify for 1031 even if the sole asset of the corporation is qualifying real estate. But as an "entity" the corporation’s property can qualify, provided the other 1031 requirements are met. (Keep RE of corporations!) – Any *entity* can exchange qualifying like-kind property, but not the *ownership interest* in the entity (does not qualify)
C-1. OTHER PROPERTY MAY NOT, OR MAY BE LIKE-KIND:

(1) A partnership or LLC Interest
(2) Real for Personal
(3) Foreign Property
(4) Intangible Property
The above are further discussed.

(1) Partnership Interest - A partnership interest does not qualify. IRC 1031(a)(2)(D). However as an "entity" the partnership itself may qualify for 1031 provided all other requirements are met including the same partnership entity continuing to hold the replacement property as like-kind investment property.

Partnership split-ups: Many times in a partnership situation, you have some partners who want to do a 1031, while the other partners who do not want to do a 1031. In this scenario the usual strategy is to dissolve the partnership and create individual "tenant-in-common" ownerships. The qualifying co-tenants can then do the 1031 rollover while the other co-owners can just sell for cash and pay the taxes. The methods for converting a partnership to co-tenants are beyond the scope of this publication. You should consult with a 1031 Exchange Tax Specialist (not a title company). With your VIP code, email us for a high-quality recommendation.

(2) Real Property for Personal Property – Where the 1031 rollover includes real property, such realty often contains certain "Personal Property" such as appliances, furniture, etc. Here the personal property will be considered non like-kind "boot" which will not disqualify the exchange, but may cause it to be partially taxable. One possible way to avoid taxability is by not listing any significant personal property in the agreements or settlement sheets. Another possible way is by having a parallel rollover of realty for realty and like-kind
personal property for personal property. The entire transaction could then be like-kind.

(3) **Foreign Property** - Property located in the U.S. and real property outside the U.S. does not qualify as like-kind, IRC 1031(h). Real property located in the U.S. and real property outside the U.S. do not qualify, IRC 1031(h). But foreign real estate for foreign real estate and U.S. real estate for U.S. real estate is like-kind. For example, you cannot rollover property from the U.S. to Canada (or vice versa). However, you can rollover property from Mexico to Canada (foreign for foreign). Of course you can rollover anywhere in the U.S*.

{*Note: It appears that the "U.S." is the 50 United States (including the District of Columbia) and no other neighbors, possessions or special treaties, except the Virgin Islands may qualify according to IRS Letter Ruling 9038030}.

(4) **Intangible Property** - Certain intangible assets such as going concern value and goodwill do not qualify as like-kind, Reg.1.1031(a)-2(c)(2). [However certain copyrights, patents, franchises, tradenames, trademarks and licenses may qualify depending on the nature or character of underlying the rights involved].

(5) **Property in a Entity Can Qualify for an Exchange** - Partnerships, LLC-partnerships, limited partnerships, corporations (C or S), certain trusts as entities can do a 1031 exchange of the entity’s property

**Requirement 7: HELD FOR INVESTMENT OR BUSINESS USE** - In a nutshell, both the relinquished and replacement properties must be held for investment or business use for a period of time and during this period the properties must not be held for resale or personal use. Internal Revenue Code Section 1031(a)(1). More specifically this (not-so-clear) requirement means the following:
(1) RENTAL, BUSINESS OR INVESTMENT USE - You must use the properties as a rental property, or for your own business-use, or as an investment such as land. {These uses were discussed previously under the like-kind requirement}.

(2) NOT PERSONAL-USE - You must not use the properties for personal use (except for the 14-day\10% exception under the vacation home provisions of IRC 280A. See Chapter 27, Part B).

A principal residence, used as such, does not qualify for a 1031 exchange. Principal residences, meeting the ownership and use provisions of Section 121, can permanently exclude taxable gains with the $250,000 exclusion for single taxpayers and $500,000 exclusion for married filing jointly, IRC 121. See the special home-owner exclusion reports on the Goldmine forms disk, GMSR1 and GMSR2.

A second or vacation home, used as such (personally), does not qualify for 1031 tax-free treatment. They could qualify for 1031 treatment if they are converted to rental use under special rules. For a further discussion refer to our member-only web site www.goldminevipacccess.com under updates February 2008.

(3) NOT INVENTORY OR PRIMARILY FOR SALE - You must not hold the properties as inventory for immediate sale to customers, such as a “dealer” would. An example of those who would be "dealers" in real estate are builders, developers and subdividers who are in the business of selling their property as “inventory” to customers in the normal course of their business. IRC 1221(1). You must not hold the properties "primarily for sale" with pre-intent to sell [Ethel Black, 35 TC 90, 1960].
**STRATEGY:** Follow the Goldmine strategies for avoiding dealer status with investment intent. See Chapters 6, 41 to 43-A and Appendix E.

(4) CONSISTENCY OF OWNERSHIP, RELINQUISHED PROPERTY TO REPLACEMENT PROPERTY - According to IRS, there should be *consistency of ownership* from the relinquished property to the replacement property without any changes for a one or two year period. The IRS has ruled that changes of ownership that are proximate to an exchange violate this holding requirement and therefore cause the exchange to be disqualified, IRS Revenue Rulings 75-292 & 77-337.

However, IRS rulings do not have the force or effect of law, plus there are several tax court cases that disagree [*Bolker*, 81 TC 782 (1983); *Mageneson*, 81 TC 767 (1983)]. Moreover, partners can elect out of partnerships and become tenants-in-common, IRC1031 (a). Despite this you should try to maintain consistency of ownership. Ideally, this consistency of ownership from the relinquished property to the replacement property should be maintained without any changes for at least six months to a year. Again, if you do not maintain such ownership consistency you still have a defensible position based on the above.

**NOTE – SINGLE MEMBER LLC:** According to IRS, transfer of property to a single-member LLC does not violate this holding requirement and should qualify without IRS controversy, IRS Private Letter Ruling 9807013.

(5) HOLDING PERIOD – HOW LONG MUST PROPERTY BE HELD?

Although there is this fundamental holding *requirement*, we do not have an objective (safe harbor) time requirement for a holding *period*. We can only look to scant precedent for some guidance. In an IRS letter ruling, the IRS ruled that a 2 year holding period would be sufficient to meet this holding period test [IRS letter ruling 8429039]. However, IRS rulings do not have the force or effect of law, plus there are tax court cases where much less time was
sufficient (*see the second note below). Conventionally, many advisors believe there should be *at least* a one to two year holding period. If you hold the property for one year, try to at least overlap into two “tax years”. Again, according to IRS, the longer you hold the properties the better.

**NOTE ON CONVERSION TO PERSONAL-USE:** After this holding period, you should be able to convert the property from investment-use to personal-use without triggering the deferred taxes.

**NOTE ON PROPERTIES QUICKLY SOLD:** Exchanges of quick sales (“flips”) could violate this exchange “holding requirement”. However, in certain situations and with advanced planning, these still may qualify. For a further discussion, see the next chapter.

**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”.

Reference Source (return tab): SAP 25, Part A
Strategies for the Tax-Free Sales of Quick Flips Via 1031 Exchanges

With the 1031 exchange “holding” requirement, conventional thinking is that a quick flip of a property will not qualify for a 1031 exchange. But, with the right planning, this is not necessarily so with the following strategies:

**Strategy 1.** Know the tax law citations that support quick sales as exchanges as follows. In one tax court case nine months was sufficient 
*Wagenson* 74 TC 683 1980]. In another case six months was enough *[124 Front St. Inc. 65 TC 6 (1975), 1976-2CB 3]. In Allegheny County Auto Mart, Inc., the property was held five days before the sale\exchange [TC Memo (1953)]. In *Rutherford*, the transfer was immediate [TC Memo 1978-505].
(Underlined emphasis added). See also *Bolker*, 81 TC 782 (1983) and *Mageneson*, 81 TC 767 (1983). *Bolker* and *Mageneson* involved the immediate changes of ownership. According to the courts, such immediate changes did not violate the exchange holding requirement. However, the IRS’s position is that they do violate the exchange [IRS Rev. Rulings 75-292 & 77-337]. But the IRS position does not have the force or effect of law. Tax court decisions could have the force or effect of law.

**Strategy 2.** Document investment intent via the Supreme Court Case, *William Malat*. Incorporate the Statement Of Investment Intent in all of your records per Ch 42 for avoiding being a dealer.

**Strategy 3.** Use and document Liquidation Of Investment. Using this argument, property owners (including “dealers”) argue that they had the requisite "investment" intent, but there were factors & circumstances beyond their control that forced them to liquidate quickly, also per Ch 42 (Avoiding
being a dealer). One of these liquidating reasons could be *special or changed market conditions*.

**Strategy 4.** Hold the purchased replacement property for at least 2 years under the "*Economic Unit*” and “*Continuity of Investment*” doctrines > the foundation of qualifying exchanges. For the replacement property, you should actually hold the property for long-term investment\rental purposes for a period of at least 2 years. This is a strong indicator of investor status, even on the quick selling side of the relinquished property. *Reason:* The underlying rationale of Section 1031 comes under the "*Continuity Of Investment*" theory, which states that if the investment in the new replacement property is substantially a continuation of the former relinquished property, then it is inappropriate to recognize theoretical gain. This is also known as the "*Economic Unit Doctrine*". Under these fundamental theories, if we look at the relinquished and replacement properties, together as one unit, there is a long period of ownership and a very strong argument for investment intent and investor status. Therefore, under these doctrines, the longer holding period of the keeper replacement property should carry over to the short “flip” period of the relinquished property. Dating back to the 1920’s, these doctrines are foundational and thus a powerful defense against the IRS. [Section 202(c) of the Revenue Act of 1921 and Section 112(d) of the Revenue Act of 1928.]

**Strategy 5.** Own long-term rental keepers and do not make quickly selling properties a full time business. Not only does this strengthen investment intent and thus help to avoid dealer status; it also is an excellent investment strategy that could make you wealthy. Also, the rental keepers should be in the same entity as the property being flipped as per previous discussions.

**Strategy 6.** Employ other strategies to strengthen the holding requirement. These are:

(a) One is taking legal title to strengthen the holding requirement. If you are wholesaling the relinquished property by assigning the contract (or option)
to your buyer ("assignee"), it does strengthen your argument if you actually 
take title (deed), even if only momentarily. **Reason:** It is unclear if a contract (or 
option) can qualify as like-kind property in a 1031. To qualify it would have to 
be considered an interest in real property. However, the courts have considered 
contract rights to purchase real property as real property rights. See *Starker v. 
US*, (CA9, 1979). At least some 1031 experts believe than treating a contract or 
option as like-kind to a fee interest in real estate is highly questionable. 
Sometimes a purchase contract extends for a lengthy period of time, such as one 
to two years. Here, because of having at least equitable title for a longer period, 
the wholesale assignment may have a better chance to qualify. Even better, if 
you have the burdens and benefits of ownership while under agreement 
(especially with the right of property possession), then you could be considered 
an equitable owner which would strengthen this holding requirement. Otherwise 
you are better off taking title*.

**NOTE ON TRANSFER FEES:** In some locales you will have to pay 
transfer fees in taking title, even if only momentarily, in most cases. If the 
transfer fees are small in relation to the capital gains taxes, it’s worth the 
extra cost. If they are high, you may have to go with the contract 
assignment and the above somewhat questionable position that contract 
rights are an interest in real property. Alternatively, you may be able to 
avoid transfer fees by taking ownership, not by deed, but by equitable 
ownership via a land contract or contract for deed. (Seek competent legal 
counsel if you are not familiar with these instruments). It is well established 
in tax law that the passage of legal title is not necessary to receive the tax 
benefits of owning real estate (including 1031’s), provided that you have 
equitable ownership along with the burdens & benefits of ownership, such 
as via a land contract. [*Fred White*, TC Memo 1974-69; *Union Pacific R.R. 
Co.* (1936, CA2) 86 F2d 637,18; *Ted Merrill* (1936) 40 TC 66. Many other 
cases can be cited]

**1031 ALERT:** *Net Selling Price if taking title - versus - Net Selling Price 
if you do not take title and assign the contract.* Before getting into the
reason for this alert, some background first. With a 1031 exchange, the minimum reinvestment in replacement property to totally defer taxes on the exchange is the *Net Selling Price* of the relinquished property which is the total selling price less selling expenses. The higher the net selling price, the higher the minimum reinvestment cost in replacement property to totally defer taxes on the exchange. Referring to the above, if you do take title to the relinquished property your net selling price of the property will be the purchase price you are paying to the property owner, plus your flip profit from your buyer (less any selling expenses). If you do *not* take title and assign the contract then it could be argued the selling price is only the flip profit, which would be lower than the property purchase price plus your flip profit. Where this will make a difference is in how much replacement property, cost-wise, you will be acquiring as part of the exchange. This would be especially so with larger commercial transactions.

**EXAMPLE**: One of my students was flipping a very large commercial property for a $2,500,000 profit based on a purchase price of $15,000,000 and selling price of $17,500,000. If he takes title, his selling price will be $17,500,000. If he does not take title and just assigns the contract he could structure the documents to indicate his selling price is the flip profit of $2,500,000. Based on the above, if he takes title his selling price of $17,500,000 would mean he would have to acquire replacement property of $17,500,000 to totally defer taxes on the exchange. This is a large amount, even in commercial transactions. On the other hand, if he does not take title and just assigns the contract, his selling price of $2,500,000 would mean he would have to acquire replacement property of only $2,500,000 to totally defer taxes on the exchange. In this scenario, this is a huge difference that could make or break a completed 1031 exchange. However, even with the assignment, it could be argued that the selling price is the full amount (in this case $17,500,000).

To better document the flip profit as the selling price (in this case $2,500,000) there should be a separate sales agreement between the investor
(the assignor) and their buyer (the assignee) with only the flip profit (in this case $2,500,000) as the selling price. There should also be a settlement sheet (HUD1) with this amount as the contract price. [If there is a 1099S (usually not the case), on the 1099 is a box for the insertion of what is called the “gross proceeds”. In a 1031 exchange transaction the amount inserted here should be zero (“0”). The box at the bottom should also be checked that the transferor (the exchangor) will “receive property or services as part of the consideration”, as this is a 1031 exchange].

Again, taking title along with the higher selling price better strengthens this holding requirement as opposed to the assignment where you are not taking tile with the lower selling price (the flip profit). However, if taking title along with the higher selling price will cause too high of a minimum cost for replacement property, then you must use the more aggressive alternative of not taking tile with the lower selling price (the flip profit). For smaller transactions, this is not as big of an issue.

**Alternate Strategy- Use An SDIRA To Shelter Flip Profits:** For the above flip transactions, especially with high selling prices, an alternative to an exchange is to use a self-directed IRA (SDIRA) to shelter the flip product. Such assignments are not a problem with self-directed IRA’s. For this strategy to work, any initial deposits must come from the IRA, not the investor; and the purchase and sales agreements should have the SDIRA as the buyer and seller, respectively, either directly on the agreements or as assignee to such agreements.

**(b) Rehabbing to strengthen the holding requirement.** The longer amount of holding time involved with rehabbing could strengthen this holding requirement.
(c) **Use a Lease-Option to strengthen the holding requirement.** If the property being flipped is rentable, consider extending the holding period with a short to mid-term lease-option, preferably at least 13 months. This would help to ensure favorable 1031 tax-free recognition. Here, you better demonstrate that you have “rental\investment” intent with your property, as per the Supreme Court case *William Malat*. (For a further discussion, see my special report, *The Lease-Option - The Sweetheart Strategy To Avoid Dealer Status, Using A Supreme Court Case Decision* on the Turbo-Exchange disk).

7. **Audit-Proof your exchange > NO audit = NO issues = NO worry.** You are taking legal positions, but still employ these audit proofing steps:

   (a) **Report property sales via exchanges on IRS form 1065.** *Reason:* At the present time, partnership returns (form 1065) are audited much less than other forms including Schedule E and corporation returns, 1120 or 1120S. (Because of its many tax disadvantages, you should not hold real estate in any type of corporation, anyway.)

   For asset protection purposes you can use a two (or more) member LLC which files a partnership return (form 1065) with its low audit profile.

   **REMEMINDER:** As discussed in Chapter 6, to help document investment intent, use the same partnership entity that holds your keepers for your flips.

   (b) **To also reduce your chances of an audit, file extensions both for your individual 1040 and partnership form 1065.** For individual (1040) extensions use IRS form 4868; they come with instructions. You should also do extensions for partnership returns (along with your individual return). Partnerships file form 7004 from April 15 to September 15. File these partnership extensions on time, otherwise there could be costly penalties. See Chapter 2 for more about filing extensions.
(c) Attach, as an audit-proofing statement, the completed, signed and notarized *Statement Of Investment Intent* (from Appendix E) to your partnership return, form 1065.

(d) Properly complete form 8824 which is the IRS schedule for reporting 1031 exchanges. It is the only exchange form that actually goes directly to the IRS. The complete and accurate filing of this exchange reporting form would mostly likely reduce your chances of an audit. For more info on how to properly do these schedules email us at taxbible@aol.com with your Renaissance VIP code.

8. Engage a Qualified Intermediary (QI) that specializes in complex exchanges, such as those combined with flips. Most attorneys and accountants are not trained to do 1031 exchanges (right). There are service companies that provide QI services which are done by non-tax professionals without specialized tax expertise. Even some of the known QI companies have declined in expertise because they have diluted themselves by having branches all over the country like a supermarket. Exchanges are valuable vehicles that can greatly enhance your wealth. But they are also complex and must be done *right*, not by a “supermarket” or a title clerk. The unfortunate result is that most exchanges are done wrong and upon audit, would be non-qualifying exchanges, costing thousands of dollars in taxes, plus interest and penalties. Exchanges need to be done, by an experienced, qualified and dedicated 1031 exchange tax specialist A QI company that I highly recommend (and one that I am also consultant to) is *CPA Exchange Services, Inc.* (*CESI*) who has done exchanges in over 40 different states. Besides the very high level of 1031 expertise, you will also receive the most personalized, courteous and prompt service you can ever imagine (not common today!)

Email us for their contact info at taxbible@aol.com with your Renaissance VIP code.

Reference Source (return tab): SAP 25, Part B
Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet) transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. TAXABLE BOOT - WHAT IS IT?

“Boot” is any taxable income in a 1031 exchange. IRS regulations do permit in one transaction a part 1031 tax-free rollover and a part taxable sale. You do not have to reinvest all of the equity in your relinquished property into another like-kind property. The difference can be received as partial taxable boot, such as cash (or other non-like property). Regulations 1.1031(b)-1; 1.1031(k)-1(f) and 1.1031(k)-1(h)(3).

NOTE: Taxable boot will always be incurred in a move-down exchange, even if you do not take out any cash (see below). Boot can also be incurred in a move-up exchange, if you take out cash during the exchange (discussed later in this chapter).
B. MOVE-DOWN 1031 ROLLOVER - MINIMUM REINVESTMENT AMOUNT IN LIKE-KIND PROPERTY NECESSARY TO COMPLETELY DEFER TAXES

If you invest in a lower-priced replacement property, the down difference between the net selling price of the relinquished property and the cost of the replacement property is taxable income (“boot”). However, the amount of this taxable boot cannot exceed the total realized gain*. (*See example below and Chapter 29 for the full computation of realized gain)

To totally defer the tax on the gain, you must invest in identified (like-kind) replacement property an amount that equals the net selling price of your relinquished property. "Net Selling Price" is the total sales price less commissions, transfer taxes and other selling expenses.

**ALERT**: Any mortgage payoffs are not part of selling expenses; do not reduce the net selling price and therefore do not enter into this particular computation.

**EXAMPLE**: The selling price of your relinquished property is $100,000 with a tax basis of $30,000. Commissions, intermediary fees and other selling expenses are $10,000. Therefore your realized gain is $60,000 ($100,000 less 30,000 basis, less $10,000 selling expenses). The mortgage\loan balance is $20,000. Your net selling price and minimum reinvestment amount is $90,000 ($100,000 price less $10,000 expenses). IRC 1031 (b); Regulation 1.1031(b)-1 and 1.1031(d)(2). It is not the $70,000 equity in the relinquished property; you do not subtract the mortgage balance of $20,000. The original basis of $30,000 also has nothing to do with this computation.

Therefore, in this example, to totally defer the taxes on your gain, you must acquire identified like-kind replacement property for a cost of $90,000 or higher. You can go higher; if you go lower you will be taxed on the difference. Thus, if you purchased a property with a cost of $80,000, you would have $10,000 of boot taxable gain. Here, of the total realized gain of $60,000,
$10,000 is taxable and the remaining $50,000 is deferred via the 1031 exchange.

**B-1. STRATEGIES FOR BOOT IN A MOVE-DOWN 1031**

1. **Take the taxable boot as cash** -- *Reason*: In the previous example, you are going to be taxed on the above $10,000 anyway as debt relief phantom (non-cash) income. So at least get the cash to pay the taxes. You should take it out as cash either at the settlement of the relinquished property, or after the final completion of the 1031 exchange. Do NOT take it out while the cash is in escrow. If you do, the entire exchange would be disqualified.

   **Note**: This strategy does not reduce boot income, but it at least it generates cash to pay taxes on the cash boot income, instead of phantom income on debt relief. Also when leveraging the replacement property, it typically entails putting less cash down with a correspondingly higher mortgage on the replacement property for the amount of the down difference.

2. **Acquire more like-kind replacement property** -- You are not limited to just one replacement property in arriving at the minimum reinvestment of $90,000 in this example. You can acquire up to 3 properties and in some cases even more. For example, if you acquire 3 replacement properties at $30,000 each or a total of $90,000, you have met the minimum reinvestment amount and thus avoid boot income.

3. **Do additional capital improvements to the replacement property via a "construction exchange"** -- Such improvements can reduce or eliminate any boot taxable gain in a move-down exchange.

For example, relinquished property has a net selling price of $200,000; cost of replacement property is $100,000; plus at least $100,000 of capital improvements equals $200,000.
NOTE: To accomplish this you must follow the special rules of a “construction” or “build-to-suit” exchange. (See Chapter VIII-11 of The 1031 Money Machine)

C. MOVE-UP 1031 ROLLOVER WITH TAXABLE BOOT - HOW TO AVOID

Taxable boot will occur in a move-up 1031 rollover, when you invest in higher-priced replacement property, do not use up all of the equity in your old property, obtain a higher (than needed) mortgage on the new property and take out the difference as cash. Because it is taken out during the exchange, this cash takeout (up to the total realized gain) is also taxable boot income. Regulation 1.1031(b)-1 and 1.1031(d)(2).

STRATEGY: If you refinance before or after the exchange, then cash takeouts in a move-up 1031 rollover can be tax-free.

MORE INFO: For a further more in-depth discussion of 1031 exchanges (including the above strategy) refer to Al Aiello’s The 1031 Money Machine.

Reference Source (return tab): SAP 25, Part C

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
In this chapter we will discuss the following:

**A. WHAT IS “INSTALLMENT SALE”?**

**B. SELLER ADVANTAGES OF INSTALLMENT SALE REPORTING**

**C. SELLER DISADVANTAGES OF INSTALLMENT SALE REPORTING**

**D. HOW TO COMPUTE GAIN VIA INSTALLMENT SALE**

**E. IMPUTED INTEREST FOR SELLER FINANCING**

**E-1. PLANNING STRATEGIES - IMPUTED INTEREST:**

**F. HOW TO ELECT IN, OR OUT OF INSTALLMENT SALE REPORTING**

**G-1. TAX DECISION OF DEFERRING TAXES VIA INSTALLMENT SALE, OR REPORTING THE ENTIRE INSTALLMENT GAIN IN THE YEAR OF SALE**

**G-2. IDEAL USE OF SELLER FINANCING INSTALLMENT SALE**

Installment Sale Computation Forms – Blank and Filled-In Formats
A. 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). As defined in IRC 453(b)(1), an “*installment sale*” is a disposition of property where at least one payment is to be received after the close of the year in which the disposition occurs. In real estate jargon, installment sale is also referred to as a “*seller takeback*”, ”*seller financing*”, ”*purchase money mortgage*”, ”*land contract*” or ”*paper*”.

B. SELLER ADVANTAGES OF INSTALLMENT SALE REPORTING

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

   (a) Federal capital gains tax  
   (b) Federal alternative minimum taxes (AMT)  
   (c) Generally, state income taxes (Check the laws of your own state).

2. It prevents the “bunching of income” all in one year and gives you the opportunity to lower your tax bracket all in one year. This in turn increases your tax saving dollars.

   **NOTE:** *Without* installment sale, in a fully taxable transaction, you would have to pay taxes on the entire realized gain, all in one year.
EXAMPLE 1: GI has a total realized gain of $100,000. Assuming a 25% total rate, GI would have to fork out $25,000 in taxes all in one year. With installment sale reporting, GI can spread out the payment of these taxes over the life of the loan.

3. By deferring gain, it can enable you to take advantage of lower tax brackets in the future, either because you will be making less taxable income, or because of tax legislation.

4. To qualify for the tax deferral of installment sale, you only have to receive just one payment in the future after the year of sale. This eliminates a “two-payment” requirement which was part of a former provision. Consequently, this can create some tax planning opportunities for all cash sales at year end. This strategy is further discussed in Chapter 39.

5. There is no limit as to the amount you may receive as down monies in the year of sale.

[Tax Note: The 30% limit on down payment monies was repealed in 1980, thus eliminating the need for the “29% down” seller transaction]

Non-Tax Advantages:

6. By charging interest on the installment debt, the seller can generate a yield that is superior than what banks pay.

7. Taking back “paper” enhances the marketability of the property, because it’s easier for buyers to purchase the property. Consequently, the property can be sold quicker and frequently at a higher price.

C. SELLER DISADVANTAGES OF INSTALLMENT SALE REPORTING
1. Installment sale does not defer the following types of tax liabilities:

(a) Taxes from depreciation recapture under IRC 1245 and 1250 (Appendix C-1 (PAPPC1))

(b) Taxes from the gains of dealer property (Chapters 41 to 43)

(c) Taxes from the recapture of tax credits, such as the rehab tax credits (Chapters 20 & 21)

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

2. A final balloon payment on the note will trigger the remainder of the taxes due (and not be able to do a 1031 exchange at this point).

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

4. Installment sale (without planning) can result in unexpected and unpleasant tax consequences, such as from a number of sources of phantom income, which is income that is fully taxed even though no cash is received.

**Note**: The above tax disadvantages are further discussed in the next two chapters.

5. By deferring gain, you may be subject to higher tax brackets in the future, either because you will be making more taxable income, or because of future tax legislation.
6. Installment sale either limits or eliminates your ability to do a 1031 exchange (depending on how much seller financing there is in a transaction). This is because a mortgage note is not like-kind property and does not qualify for Section 1031. Only the cash portion of the sale can qualify for Section 1031 non-recognition treatment. See Chapter 39-B.

**Non-Tax Disadvantages:**

7. While you are deferring taxes with installment sale, you are also deferring the receipt of cash, which could be immediately invested elsewhere. If the return on alternative investments exceeds the interest on the installment debt, you are in effect losing money. (At least in part, this disadvantage could be offset by selling the note for cash. See Chapter 38 for the sale or disposition of notes.)

8. The risk of buyer default on the installment obligation. (At least in part, this could turn into an advantage. If the seller has to foreclose, they can sell the property again.)

**D. HOW TO COMPUTE GAIN VIA INSTALLMENT SALE**

With installment sale reporting, a certain “profit” percentage of the down payment and principal payments is recognized as taxable gain. This percentage is called a “Gross Profit Ratio”, which is based on the gross profit (or realized gain) from the sale (defined below). The gross profit ratio (or percentage) is computed by dividing the gross profit by the contract price (defined below). Next, principal payments are multiplied by the gross profit ratio to arrive at the recognized (or taxable) gain. This two-step computation is summarized below:

<table>
<thead>
<tr>
<th>Step</th>
<th>Gross profit (GP)</th>
<th>Gross profit ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>1:</td>
<td>Contract price (CP) = Gross profit ratio</td>
<td></td>
</tr>
</tbody>
</table>
Step 2: Payments received x GP ratio = Recognized (or taxable) gain.

The taxable gain is then multiplied by the applicable tax rate to arrive at the tax liability.

**GOLDMINE FORM**: See the Installment Sale Computation Form at the end of this chapter including a filled in version from Example 2 of this chapter illustrating the installment sale computation. Also in Appendix D-1.

**Installment Sale Formula Definitions**:

1. **GROSS PROFIT (GP)** -- The total selling price, less selling expenses (or *net selling price*) less the adjusted basis of the property (Note: *gross profit* is essentially the same as the *realized gain* on the disposition of the property.

2. **CONTRACT PRICE (CP)** -- The gross (not “net”) selling price of the property, less any mortgages (or debt) assumed or taken subject to by the buyer. If the assumed debt exceeds the adjusted basis of the property, the excess is added to the contract price and is considered a payment received (which is # 3, next). The CP is usually the total selling price.

3. **PAYMENTS RECEIVED** -- These include principal cash (or cash equivalents) received from the buyer\borrower. Payments include the buyer’s down payment (in the year of sale), the principal portion of the installment note and principal balloon payments.

**ALERT ON “PAYMENTS”**: Payments (which are subject to tax) also include “cash equivalents” plus numerous economic benefits, many of which are not cash, but phantom income (which is income that is fully taxed even though no cash is received). Payments do *not* include the interest portion of the installment
note. Such interest is separately reported as ordinary income. For a further discussion of “payments”, and related traps, see the next chapter.

**ALERT:** Commissions and other selling expenses do not reduce the above payments in the first year of sale, even though they reduce the gross profit, Reg. 15A.453-1(b)(V).

For simplicity purposes, the ensuing examples will assume a 20% federal and state tax rate.

**EXAMPLE 2:** Taxpayer is selling non-dealer property, which has been held for the long-term capital gain period, with the following data:

**Income Tax Data:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total selling price</td>
<td>$100,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>-30,000</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>-10,000</td>
</tr>
<tr>
<td>Gross profit (or realized gain)</td>
<td>60,000</td>
</tr>
<tr>
<td>Depreciation recapture</td>
<td>none</td>
</tr>
</tbody>
</table>

**Terms of Sale:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller takeback (installment sale)</td>
<td>$70,000</td>
</tr>
<tr>
<td>Buyer’s cash downpayment</td>
<td>$30,000</td>
</tr>
<tr>
<td>Existing debt to be assumed</td>
<td>none</td>
</tr>
<tr>
<td>Total selling price</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

**Payments Received (first year):**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Down payment</td>
<td>$30,000</td>
</tr>
<tr>
<td>Principal pmts during the year</td>
<td>478</td>
</tr>
<tr>
<td>Total payments rec’d for the year</td>
<td>$30,478</td>
</tr>
</tbody>
</table>

**Gross profit ratio:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross profit (or realized gain)</td>
<td>$60,000</td>
</tr>
</tbody>
</table>
Divided by contract price $ 100,000 (in this example is also the total selling price)
= Gross profit ratio 60%

**Taxable Gain:** The recognized (or taxable gain)* using installment sale for the first year is: $30,478 (Payments) x 60 % (GP ratio) = $18,287, the recognized or taxable gain.

Therefore, in the first year, of the total $60,000 gain $18,287 is taxable and the remaining $41,713 is deferred into the future.

**Tax Impact (first year):** Assuming a 20%* federal and state long-term capital gain rate, the tax liability on the $18,287 is $3,657. (The first year’s interest of $6,281 is taxed as ordinary income)

* **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 lower rates. With installment sale reporting, the gain from straight-line depreciation is taxed *first* at the maximum rate of 25%, with the remaining long term capital gain taxed at lower rates. (*Taxpayers Relief Act of 1997*)

**EXAMPLE 3:** Same facts as Example 1, except that of the $60,000 realized gain, $10,000 is from straight-line (SL) depreciation. Now, the first $10,000 of the gain will be taxed at the higher 25%. The remaining gain will be taxed at 20%, the assumed capital gain rate.

**Tax Impact:** The above $18,287 installment gain is now taxed as follows:

(1) $10,000 SL depreciation at the higher rate of 25% = a tax liability of $2,500
(2) The remaining balance of 8,287 at 20% = a tax liability of $1,657.

(3) Total tax liability is $2,500 + 1,657 = $4,157 (compared to $3,657 from Example 1).

**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 actual “depreciation recapture” is not entitled to tax deferral via installment sale. Instead, such depreciation recapture is taxed in full at higher ordinary income rates. Installment sale as it relates to depreciation recapture is discussed in Chapter 37. Depreciation recapture (itself) is discussed in Chapter 30-A.

**ALERT:** If the property is sold before the long-term capital gain holding period, the ordinary income for a Section 1231 rental property (or short-term capital gain for land) will be subject to the highest ordinary income rates. This also pertains to future payments.

**NOTE:** For purposes of simplicity, in the examples in the ensuing chapters, I will use a total rounded 20% rate for capital gain and 40% for ordinary income, unless stated otherwise.

**Recomputing The Gross Profit Because of Subsequent Price Adjustments:**
Sometimes during the holding of a mortgage, the buyer and seller agree to reduce the purchase price. If such a price adjustment occurs, then both buyer and seller must make tax adjustments. For the seller this involves recomputing the gross profit and the gross profit ratio. For a further discussion of how this is done, see Appendix D (PAPPD).

**Accrual method taxpayers can again use installment sale reporting, retroactive to the time that a prior provision disallowed them from doing so, December 16, 1999.** (The Installment Tax Correction Act of 2000)
**TIP:** Generally you should use the cash method instead of the accrual method for your tax accounting. *Reason:* The cash method is simpler and can be useful for shifting income and expenses from one year to another.

**E. IMPUTED INTEREST FOR SELLER FINANCING**

1. **The Provision:** The tax law requires a minimum amount of interest to be charged for seller-financed transactions, IRC 483 and IRC 1274. If the minimum rate is not charged (and the IRS picks this up), then the IRS imputes interest as the minimum applicable rate (discussed below). Such imputing will require the seller and buyer to treat part the sales\purchase price as interest, even though no interest was stated in any agreements. See Example 4, below.

2. **Reason For This Provision:** To prevent the seller from converting higher taxed ordinary income into lower taxed capital gain.

**EXAMPLE 4:** An investment property (held for the required long-term capital gain period) is sold on the installment-sale basis for $200,000 with no interest being charged. Assume the IRS imputes interest of $10,000. Now $190,000 is allocated to the sales price and principal amount of the debt, while $10,000 is the imputed interest, deductible by the buyer and taxable to the seller. Consequently, the $10,000 is taxed to the seller at higher ordinary income rates. Had the $10,000 remained part of the selling price then it would be taxed at lower capital gain rates.

**Note 1:** Imputed interest does not change the amount of the selling price or loan payments, just the income type, capital vs. ordinary.

**Note 2:** Correspondingly the buyer can deduct the imputed interest (here $10,000) assuming the property is held for rental or business use. If personal use, then the interest is not deductible.
3. Required Minimum Interest Rates Depends On The Amount of Seller Financing:

(a) If the seller financing is $4,913,400 or less (in 2008), then the minimum required interest is the lower of 9% or the “Applicable Federal Rate” or AFR (defined below). Note that in recent years the AFR has been lower than 9%.

(b) If the seller financing exceeds $4,913,400 or less (in 2008), then the minimum required interest is the “Applicable Federal Rate” or AFR. (Note: The above $4,913,400 is subject to change in future years. For an update email us or refer to IRS pub. 537).

4. Applicable Federal Rates: The IRS determines the Applicable Federal Rate or AFR every month. The AFR is published at the beginning of each month in the Internal Revenue Bulletin. According to IRC 1274(d)(1), there are three AFR rates depending on the term of the mortgage contract.

   a) Short-term AFR - a term of 3 years or less
   b) Mid-term AFR - a term of 3 years, but not over 9 years
   c) Long-term AFR - a term of over 9 years.

The seller will use the AFR that pertains to the term of their mortgage. Keep in mind that the above are the required minimum rates that must be charged. You could charge higher rates (provided you are not violating any other laws, such as state usury rules)

5. Imputed Interest Rules Do Not Pertain To The Following Scenarios:

(1) Payments due within six months after the closing, IRC 483(c)(1).
(2) Where the sales price is less than $3,000*, IRC 483(d)(2). (*Comment: Where?)
(3) Sales of raw land between family members, if the sales price does not exceed $500,000. Here the minimum interest rate required is 6% compounded semiannually, IRC 483(e).

(4) Property transferred between spouses or incident to a divorce under IRC 1041, Reg. 1.483-1(c)(3)(i).

(5) On a debt that is assumed or taken subject-to, Reg. 1.483-1(d).

Note: For sale and leaseback arrangements, the required minimum interest rate is higher as it must be equal to 110% of the AFR, IRC 1274(e).

**E-1. PLANNING STRATEGIES - IMPUTED INTEREST:**

1. **For the seller, convert ordinary income into capital gain by raising the price and lowering the interest rate.** This was illustrated in Example 4 above. Here, there is latitude to do some planning even with imputed interest rules. For one thing, the AFR has been lower than 9%. Moreover, you may determine the lowest AFR for the 3-month period ending with the month in which a binding written binding sales agreement has been executed, IRC 1274(d)(2).

   Also, a rate lower than the AFR may be used, if the taxpayer can show that the borrower could obtain a loan at a lower rate on an arm’s length basis, IRC 1274(d)(1)(D). Finally, no interest has to be imputed on the first six months of payments as per number (1), above.

2. **For the buyer, do the opposite, lower the price and raise the interest rate.** This will increase interest deductions for the buyer.

   **INVESTMENT TIP:** Don’t let the tax tail wag the financial dog! Before manipulating the price and the interest rate for tax purposes, you should do it to
meet the nontax needs of the parties. For instance, some sellers are “price” conscious, while others are “interest-rate” conscious. The same with buyers. When negotiating for something you want, you need to meet the needs of the other parties. That is, hit their “hot buttons”. Once you do this, you can then structure tax planning strategies accordingly. For example, you as a buyer (esp. as a buyer), or even a seller want to agree to very low or no interest below the IRS AFR, well go ahead. The worst case the IRS imputes the interest. Such imputing does not change the total amount of the loan payment, just the tax character of the payments which would include some interest instead of all principal. It’s the same deal, plus the IRS imputing interest is not very likely; and if IRS does do so, I do not know of any penalty for taxpayers not including interest with installment sale\seller financing.

F. HOW TO ELECT IN OR OUT OF (REVOKE) INSTALLMENT SALE REPORTING

1. Reporting: Installment sale is an automatic election, IRC 453(d)(1). It is reported on IRS Form 6252 and Schedule D. (However, it is not automatic with certain related party sales, discussed in Chapter 37.)

TAX ALERT: Losses on the sale or disposition of investment real estate may not be reported on the installment basis. The entire loss must be recognized and reported in the year of the closing, Revenue Ruling 70-430. See Chapter 44 for loss-year strategies on the disposition of real estate.

2. 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); Reg. 15A.453-1(d)(3).

3. Revoking a Late Election To Elect Installment Sale Reporting, or Revoking a Late Election To Elect Out of Installment Sale Reporting:
Revoking elections (in or out) beyond the due date of the tax return (plus extensions) is not allowed, unless in those rare circumstances when the IRS concludes that the taxpayer had good cause for failing to make a timely election, Reg. 15A.453-1(d)(3)(ii).

**ALERT:** A revocation will not be permitted when one of its purposes is the avoidance of federal income taxes, or when the tax year in which any payment was received has closed, Reg.15A.453-1(d)(4). For example the following are not good reasons for revocations - an increase in tax rates in a later tax year or the taxpayer’s desire to simplify their tax reporting. Revenue Ruling 90-46.

**TAX BREAK:** However, oversights or errors by the taxpayer’s advisors may constitute a good cause for revoking prior elections.

(a) Revoking a Prior Election Out - In this scenario the taxpayer originally elected out of installment sale and reported the entire gain. In a private letter ruling, the IRS allowed the revoking of the election out of installment sale, where the taxpayer’s accountant made the erroneous assumption that the entire sales proceeds were received in the year of closing. The taxpayer had intended to make an election for installment sale reporting. Their failure to do so was unintentional and they promptly corrected the error after it was discovered. IRS Private Letter Ruling 8938067.

(b) Revoking a Prior Election In - In this scenario the taxpayer originally elected installment sale and deferred the gain via installment sale. Here, the IRS may allow the revoking of the election of installment sale. **Reason:**
The failure of the taxpayer’s return preparer to make a timely election out of installment sale, Rev. Rul. 90-46.

**STRATEGY:** Blame the tax preparer!

3A. **How to Revoke:** Revoking a prior election will only be allowed with the consent of the IRS, IRC 453(d)(3). The request must be made in accordance with special administrative procedures. See IRS Revenue Ruling 90-46.

**G-1. TAX DECISION OF DEFERRING TAXES VIA INSTALLMENT SALE, OR REPORTING THE ENTIRE INSTALLMENT GAIN IN THE YEAR OF SALE**

There is also 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. For a further discussion of this important decision, refer to Chapter 39-A.

**G-2. 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 of the capital gain taxes.

Installment sale computations forms follow on the next page.

**Installment Sale Computation Form – Blank Format**

**A. Terms of Sale:**
1. Seller takeback (terms of note: __%__ yrs.) $__________
2. Plus: Buyer’s downpayment (cash or other prop.) +__________
3. Plus: Existing debt assumed or taken subject to + ____________
4. = Total selling price........................................... =$__________

B. Gross Profit:
5. Total selling price (line 4 above)................. $__________
6. Less: Adjusted basis........................................... - ____________
7. Less: Selling expenses................................. - ____________
8. = Realized gain................................................. = ____________
9. Less: Depreciation recapture (fully report as OI) - ____________
10. = Gross profit (for GP ratio).......................... = ____________

C. Contract Price:
11. Total selling price (line 4 above)................... $__________
12. Less: Existing debt assumed or taken subject to - ____________
13. Plus: Excess-of-debt-over-basis.................... + ____________
14. = Contract price............................................... = ____________

D. Gross Profit Ratio:
15. Gross profit (line 10 above)........................ $__________
16. Divided by contract price (line 14 above)........ / ____________
17. = Gross profit ratio........................................... = ____________

E. Payments Received (first year of sale):
18. Cash down payment................................. + ____________
19. Plus: Market value of property other than cash + ____________
20. Plus: Principal pmts during the year.............. + ____________
21. Plus: Excess-of-debt-over-basis (line 13 above) + ____________
22. Plus: Other payments (see Section 36)............ + ____________
23. = Total payments rec’d - year of sale.............. = ____________

F. Recognized (Taxable) Gain In Year of Sale:
24. Total payments rec’d - year of sale (line 23)..... $__________
25. X Gross profit ratio (line 17 above)............... X __ %
26. = Recognized (taxable) gain in year of sale..... = ____________

G. Recognized Gain In Years After Sale:
27. Total principal payments for the ________ year $__________
28. X Gross profit ratio (line 17 above)............... X ____________
29. = Recognized (taxable) gain for the year....... = ____________
### Installment Sale Computation Form - Filled-In - From Example 2

#### A. Terms of Sale:
1. Seller takeback (terms of note: 9%, 30\5 yrs.) $ 70,000
2. Plus: Buyer’s downpayment (cash or other prop.) + 30,000
3. Plus: Existing debt assumed or taken subject to + 0
4. = Total selling price $ 100,000

#### B. Gross Profit:
5. Total selling price (line 4 above) $ 100,000
6. Less: Adjusted basis - 30,000
7. Less: Selling expenses - 10,000
8. = Realized gain 60,000
9. Less: Depreciation recapture (fully report as OI) - 0
10. = Gross profit (for GP ratio) $ 60,000

#### C. Contract Price:
11. Total selling price (line 4 above) $ 100,000
12. Less: Existing debt assumed or taken subject to - 0
13. Plus: Excess-of-debt-over-basis + 0
14. = Contract price $ 100,000

#### D. Gross Profit Ratio:
15. Gross profit (line 10 above) $ 60,000
16. Divided by contract price (line 14 above) / 100,000
17. = Gross profit ratio 60%

#### E. Payments Received (first year of sale):
18. Cash down payment + 30,000
19. Plus: Market value of property other than cash + 0
20. Plus: Principal pmts during the year + 478
21. Plus: Excess-of-debt-over-basis (line 13 above) + 0
22. Plus: Other payments (see Section 36) + 0
23. = Total payments rec’d - year of sale $ 30,478

#### F. Recognized (Taxable) Gain In Year of Sale:
24. Total payments rec’d - year of sale (line 23) $ 30,478
25. X Gross profit ratio (line 17 above) X 60%
26. = Recognized (taxable) gain in year of sale $ 18,287

#### G. Recognized Gain In Years After Sale:
27. Total principal payments for the 2nd year $ 523
28. X Gross profit ratio (line 17 above) X 60%
29. = Recognized (taxable) gain for the year ........ $ 314

Reference Source (return tab): SAP 26, Part A

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
As discussed in the previous section, “payments” received are the part of the installment sale that are subject to taxation. The amount of the payment taxed will depend on the gross profit ratio. The method of computing the gross profit ratio was also discussed in the previous section.

In this chapter we will discuss the following:

A. WHAT ARE NOT “PAYMENTS”

B. WHAT ARE “PAYMENTS”

B-1. PAYMENTS THAT ARE CASH

B-2. PAYMENTS THAT ARE ALMOST LIKE CASH OR CASH EQUIVALENTS

B-3. PHANTOM PAYMENTS THAT ARE NON-CASH TAXABLE PHANTOM INCOME IN THE YEAR OF SALE

C. STRATEGY: ELIMINATE INSTALLMENT SALE REPORTING (AND THE ABOVE TAXABLE PHANTOM INCOME) WITH OTHER STRATEGIES

D. TAX ALERT ON ESCROW ARRANGEMENTS
A. WHAT ARE NOT “PAYMENTS”

Before listing what are payments, the following are not taxable payments, and are called “qualifying indebtedness”:

1. The buyer’s installment note (the seller financing, itself), IRC 453 (f)(3); Reg. 15A.453-1(b)(3)(i).
2. Mortgage debt that is directly assumed or taken subject to by the buyer (But the excess-of-debt over basis is a payment), 15A.453-1(b)(3)(i).

3. Certain other debts of the property assumed or paid by the buyer, such as taxes, interest, liens, Reg. 15A.453-1(b)(2)(iv). (But the excess-of-debt over basis is a payment), Reg. 15A.453-1(b)(3)(i).

4. Third party guarantees and letters of credit to secure payment, Reg. 15A.453-1(b)(3)(i) and (iii). (See Appendix D for a further discussion)

Also, not considered to be payments are:

5. The interest portion of the installment note. Such interest is separately reported as ordinary, “interest” income, IRC 61(a)(4).

6. Any like-kind replacement property received as part of a combination 1031 exchange and installment sale, Reg. 1.1031(k)-1(j)(2); IRC 453(f)(6).

B. WHAT ARE “PAYMENTS”

**Alert:** Payments have a much broader scope than the typical meaning of the word. Payments (which are subject to tax) not only include principal cash received, but also include “cash equivalents”, securities, and other assets.
Payments also include many economic benefits which result in *phantom income*, which is income that is fully taxed even though no cash is received. A list of payments in the first year of sale (cash, almost-cash and phantom payments) are the following:

**B-1. PAYMENTS THAT ARE CASH**

1. Initial cash down payment, Reg. 15A.453-1(b)(3)(i).
2. Other cash, such as cash at the settlement, Reg. 15A.453-1(b)(3)(i).

**B-2. PAYMENTS THAT ARE ALMOST LIKE CASH OR CASH EQUIVALENTS BUT ARE PAYMENTS**

2. Marketable securities where there is an established security market, such as stocks, IRC 453(f)(2); Reg. 15A.453-1(b)(3)(i).
3. Corporate or government bonds or other debt issued with either (a) interest coupons attached or in a registered form (other than those in which the taxpayer established that are not readily tradable in an established security market) or (c) in any other form to render such bond or debt readily tradable in an established security market, IRC 453(f)(5)

4. Any third party debt that is payable on demand, IRC 453(f)(4).

**B-3. PHANTOM PAYMENTS THAT ARE NON-CASH TAXABLE PHANTOM INCOME IN THE YEAR OF SALE**

These are listed first and then further discussed.

**PAYMENT 1**: Sales expenses of the seller paid by the buyer, such as legal fees and commissions, Reg. 15A.453-1(b)(2)(iv).

**PAYMENT 2**: Cancellation of any debt owed by the seller to the buyer, Reg. 15A.453-1(b)(3)(i); RR 76-398; RR 71-515.

**PAYMENT 3**: Prior years’ untaxed options or deposits being applied toward the purchase price, Reg. 15A.453-1(b)(3)(i); RR 73-360.

**PAYMENT 4**: Non-cash property received -- Notes or other debt of third parties (other than the buyer) that are assigned to the seller as part of the sales consideration, Reg. 15A.453-1(b)(3)(i).
**PAYMENT 5:** Non-cash property received -- Market value of property received, other than cash (such as real estate, a car, a boat, etc.), Reg. 15A.453-1(b)(3)(i).

**PAYMENT 6:** The buyer’s payoff of an existing mortgage on the property, if paid off in the year of sale and not assumed by the buyer, *Sterling* (DC) 3 USTC 3 F. Supp. 386.

**PAYMENT 7:** “11th Hour Refinancing”. Where the taxpayer does a cash out refinance on a property, pockets the cash, quickly sells the property and elects installment sale by having the buyer assume (or take subject to) the new mortgage. This newly incurred debt in “contemplation of disposition of the property” may be considered a taxable payment instead of non-taxable qualified debt, Reg. 15A.453-1(b)(2)(iv).

**PAYMENT 8:** Excess-of-debt-over-basis, if the debt is directly assumed by (or taken subject to) the buyer, Reg. 15A.453-1(b)(3)(i). – Using a wrap-around mortgage.

1. **PAYMENT 1:** Sales expenses (and certain other debts) of the seller paid by the buyer [Reg. 15A.453-1(b)(2)(iv)]

Initial payments also include payments by the buyer for seller transaction costs such as commissions and legal fees. Also included here are other debts of the seller, even if the debt is not related to the transaction. Examples of the latter are the buyer’s paying the seller’s past due credit cards, medical expenses, car payments, etc. These payments to third parties are considered to be a payment to the seller, Reg. 15A.453-1(b)(2)(iv). Even though the seller receives no cash, they pay taxes on this phantom income.

**EXAMPLE 1:** Taxpayer is selling non-dealer property. Assume that the taxpayer/seller is obligated to pay the $10,000 real estate commission via a
listing agreement. In the first year the buyer makes no direct principal payments to the seller but pays the $10,000 commission directly to the real estate agent. Below is the following data:

**Income Tax Data:**
- Selling price: $100,000
- Adjusted basis: -30,000
- **Selling expenses (commission)**: -10,000 (directly paid by the buyer)
- Gross profit (or realized gain): = 60,000
- Depreciation recapture: none

**Terms of Sale:**
- Seller takeback (installment sale): $90,000
- Buyer’s direct cash down payment: none
- **Buyer to pay commission directly**: $10,000
- Total selling price: $100,000

**Payments Received:**
- Buyer’s direct cash down payment: none
- Principal pmts during the year: none the first year
- **Buyer to pay commission**: $10,000
- Total payments received: $10,000 (all phantom income)

Gross profit (or realized gain): $60,000
Contract price: $100,000
Gross profit ratio: 60% ($60,000\100,000)

**The Taxable Is Phantom Gain:**

$10,000 (Payments) \( \times \) 60% (GP ratio) = $6,000, the recognized or taxable gain.

**Total Tax Impact:** The above $6,000 taxable gain, is non-cash, (“phantom”) income as there is no actual cash received. Assuming a 20% rate, the tax liability on the $6,000 is $1,200.
**Total Negative Cash Impact:** The end result is that the seller would have to come up with $1,200 out of their pocket to pay the taxes.

**STRATEGIES:**

**Strategy 1:** Obtain more of a cash down payment to cover all of the taxes.

**EXAMPLE 2:** Same facts as Example 1, except you reduce the seller takeback by $1,500 and obtain another $1,500 cash down or a total of $11,500 in payments ($10,000, plus the $1,500, which is *cash*).

$11,500 (Payments) \times 60\% \text{ (GP ratio)} = 6,900$, the recognized or taxable gain.

**Total Tax Impact:** Assuming a 20\% federal capital gain rate, the tax liability on the $6,900 is **$1,380**.

**Total Cash Impact (is now positive):** With the $1,500 cash to pay the taxes of $1,380, the seller has net positive cash $120 in their pocket.

**Strategy 2:** Have the buyer be legally liable to directly pay the $10,000 Realtor commission. The higher the payments, the higher the taxable gain. If any selling expenses (such as commissions) are shifted to the buyer, and the selling price and payments are reduced by this shifted amount, the taxable gain in the year of sale is reduced. (The same would true for other seller expenses such as legal fees.)

**EXAMPLE 3:** Assume the same facts as Example 1. Instead of giving the seller a $100,000 selling price, the buyer is to pay the $10,000 commission directly. This would correspondingly reduce the payments and selling price by $10,000. **For this strategy to work, the buyer would have to be legally liable to pay the commission by signing an agreement with the real estate agent.**
With this change, the sales price is reduced from $100,000 to $90,000, which is also the new contract price. Also, because the buyer is paying the $10,000 commission, the total payments of $10,000 is reduced to none. The gain or gross profit is still $60,000 ($90,000 selling price less the basis of $30,000. There is no more $10,000 commission as a selling expense). When the $60,000 gross profit is divided by the $90,000 contract price, there is now a 67% gross profit ratio. But the payments received are NONE.

**NO Payments x 67 % (GP ratio) = NO taxable gain.**

**Total Tax Impact = NONE. NO taxes due.**

**Total Cash Impact = NONE. NO negative cash impact.**

### 2. PAYMENT 2: Cancellation of any debt owed by the seller to the buyer

[Reg. 15A.453-1(b)(3)(i); RR 76-398; RR 71-515]

If you, the seller, owe the buyer a previous debt, and as part of the selling price the buyer agrees to forgive your debt, the amount of such debt is an initial (phantom) payment.

**EXAMPLE 4:** Same facts as Example 1, except you previously owed the buyer $10,000 for a loan. As part of the consideration being paid for the property, the buyer also agrees to cancel the $10,000 obligation (as well as pay for the $10,000 commission). Now, your total initial payments are increased from $10,000 to $20,000. The installment obligation is reduced to $80,000. Below is the following data:

**Income Tax Data:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$100,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>$30,000</td>
</tr>
<tr>
<td>Selling expenses (commission)</td>
<td>$10,000</td>
</tr>
</tbody>
</table>

(directly paid by the
Gross profit (or realized gain) = 60,000  
Depreciation recapture = none

Terms of Sale:  
Seller takeback (installment sale) $ 80,000  
Buyer to pay commission directly $ 10,000  
Buyer’s cancellation of seller debt $ 10,000  
Total selling price $ 100,000

Payments Received:  
Buyer’s direct cash down payment none  
Principal pmts during the year none the first year  
Buyer to pay commission directly $ 10,000  
Buyer’s cancellation of seller debt $ 10,000  
Total payments received $20,000 (all phantom income)

The gross profit ratio is the same at 60%, but with higher taxes with more payments.

$20,000 (Payments) x 60% (GP ratio) = $12,000, the recognized or taxable gain.

Total Tax Impact (is higher): The above $12,000 taxable gain, is non-cash, (“phantom”) income and there is no actual cash received. Assuming a 20% federal capital gain rate, the tax liability on the $12,000 is $2,400.

Total Negative Cash Impact (is even more): The end result is that the seller would have to come up with $2,400 out of their pocket to pay the taxes.

STRATEGIES: Follow the same planning recommendations as before: (1) Obtain more of a cash down payment to cover all of the taxes; (2) Have the buyer be legally liable to directly pay seller transaction costs. (3) Another tax planning strategy in these phantom income situations is to look for tax losses or deductions to reduce taxable gain. For example, any loser stocks or bonds that
can be sold by the end of the year will generate capital losses which can be used to fully offset capital gains from real estate. A business loss, retirement plan contribution and many other deductions can do the same. Loss strategies are further discussed in Chapter 44. Also see Appendix G for year-end tax strategies.

3. **PAYMENT 3**: Prior untaxed option deposits or earnest money deposits applied toward the purchase price [Reg. 15A.453-1(b)(3)(i); RR 73-360]

Option payments give the buyer the right to buy a property at a future date. For the seller, option payments are generally tax deferred because it is an open transaction until the option is exercised, sold or expired. The same would also hold true for earnest money deposits. (Options are further discussed in Chapter).

An option (or earnest money deposit) payment received in the form of cash is obviously not phantom income. However, if the payment is received in a year prior to the sale and the seller elects to defer the payment, then when the payment is exercised in a later year, it becomes part of the selling price. In the later year of exercise, the prior option or deposit payment is phantom income. With installment sale, the phantom option amount is an initial “payment”, triggering taxable gain.

**EXAMPLE 5**: In a prior year you received a $20,000 non-refundable option deposit on the property. In that year, you elected to defer the taxability of the option payment. This year, you settle on the property, taking back financing, elect installment sale and credit the buyer for the $20,000 option deposit. Even though you received it in a prior year, the $20,000 is an initial (phantom) payment in this year of sale. Assuming a 60% gross profit ratio, 60% of the $20,000 or $12,000 is taxable gain, which at a 20% tax rate, would result in a tax liability of $2,400.
STRATEGIES:

Strategy 1: Keep the option payment in a segregated, liquid, interest-bearing account until the option is exercised or expires. Here, you will avoid phantom income by having the liquid cash (plus earnings) to pay the taxes. (On the negative side, you forgo the immediate use of the cash for other higher-yielding investments.)

Strategy 2: Follow the same planning recommendations as before: (1) Obtain more of a cash down payment to cover all of the taxes; (2) Have the buyer be legally liable to directly pay seller transaction costs; (3) Look for tax losses or deductions to reduce taxable gain, such selling a loser stock or retirement plan contribution.

4. PAYMENT 4: Non-cash property received -- Notes or other debt of third parties (other than the buyer) that are assigned by the buyer to the seller as part of the sales consideration [Reg. 15A.453-1(b)(3)(i)].

EXAMPLE 6: You are selling a property for $100,000, with a gross profit of $60,000 and therefore a gross profit ratio of 60%. The property is owned free & clear of debt. As far as the terms of the sale, you will hold back financing for $90,000. The buyer holds a note-receivable (from another debtor) in the amount of $10,000. For the $10,000 down payment the buyer assigns this note to you (the seller) so you will be the owner of the note, entitled to collect on the note. The $10,000 note is a phantom payment.

$10,000 (Payment) x 60% (GP ratio) = $6,000, the recognized or taxable gain.

Total Tax Impact: The above $6,000 taxable gain, is non-cash, (“phantom”) income as there is no actual cash received. Assuming a 20% rate, the tax liability on the $6,000 is $1,200.
**Total Negative Cash Impact:** The end result is that the seller would have to come up with $1,200 out of their pocket to pay the taxes.

**5. PAYMENT 5:** Non-cash property received -- The market value of property received other than cash, such as real estate, a car, a boat, etc. [Reg. 15A.453-1(b)(3)(i)]

**EXAMPLE 7:** Same facts as the above example, except instead of receiving a $10,000 note, your buyer gives you a car worth $10,000 for the down payment. The result is exactly the same as above.

**STRATEGIES FOR 4 & 5:** Follow the same planning recommendations as before: (1) Obtain more of a cash down payment to cover all of the taxes; (2) Have the buyer be legally liable to directly pay seller transaction costs. (3) Look for tax losses or deductions to reduce taxable gain.

**6. PAYMENT 6:** The buyer’s payoff of an existing mortgage on the property, if paid off in the year of sale and not assumed by the buyer, [Sterling (DC) 3 USTC 3 F. Supp. 386]

**EXAMPLE 8:** You are selling a property for $100,000, with a gross profit of $60,000 and therefore a gross profit ratio of 60%. The property has an existing assumable mortgage of $40,000. You will hold as selling financing the remaining balance of $60,000. The property is free & clear of other debt. Instead of assuming your existing mortgage of $40,000, the buyer decides to pay it off in the year of sale. The $40,000 payoff is a phantom payment.

$$40,000 \times 60\% \ (GP \ ratio) = 24,000$$, the recognized or taxable gain.
**Total Tax Impact:** The above $24,000 taxable gain, is non-cash, ("phantom") income and there is no actual cash received. Assuming a 20% rate, the tax liability on the $24,000 is $4,800.

**Total Negative Cash Impact:** The end result is that the seller would have to come up with $4,800 out of their pocket to pay the taxes.

**STRATEGIES:**

**Strategy 1:** Have the buyer agree to assume the mortgage instead of paying it off, or do a wrap around mortgage (see payment 8). Here, you will avoid phantom income. (But you have to consider the economics of not having the buyer pay off your debt.)

**Strategy 2:** Follow the same planning recommendations as before: (1) Obtain more of a cash down payment to cover all of the taxes; (2) Have the buyer be legally liable to directly pay seller transaction costs. (3) Look for tax losses or deductions to reduce taxable gain, such selling a loser stock or retirement plan contribution.

**7. PAYMENT 7:** “11th Hour Refinancing” -- Where the taxpayer\seller does a cash out refinance on a property, pockets the cash, quickly sells the property and elects installment sale by having the buyer assume (or take subject to) the new mortgage. This newly incurred debt in “contemplation of disposition of the property” may be considered a taxable payment instead of non-taxable qualified debt [Reg. 15A.453-1(b)(2)(iv)].

This provision is subject to controversy as to when is a debt in “contemplation of disposition of the property”, and when is it not. Apparently, it boils down to this, if the debt is incurred before deciding to sell the property, then probably such
EXAMPLE 9: RF owns a property worth $100,000, free & clear of debt. The property has a tax basis of $60,000, a gross profit of $40,000, and a 40% GP ratio. RF refinances the property for $70,000 (cash out). RF pockets the $70,000 cash, quickly sells the property and elects installment sale by having the buyer assume (or take subject to) the new mortgage of $70,000. RF holds the remaining $30,000 as a second mortgage.

Below are two different tax results, which follow with a further discussion:

(1) The regs are applicable and the assumed mortgage is a taxable payment, or

(2) The regs are not applicable and the assumed mortgage is not a taxable payment.

(1) Tax Result if Reg. 15A.453-1(b)(2)(iv) Is Applicable: The full $70,000 mortgage assumption is a payment because this newly incurred debt is “contemplation of disposition of the property”. $70,000 x 40% (GP ratio) = $28,000, the taxable gain.

Total Tax Impact: The above $28,000 taxable gain, is non-cash, (“phantom”) income and there is no actual cash received. Assuming a 20% rate, the tax liability on the $28,000 is $5,600.

Total Negative Cash Impact: The end result is that the seller would have to come up with $5,600 out of their pocket to pay the taxes. (Note: This scenario is not completely phantom income as the seller did “cash out” prior so the sale)

(2) Tax Result if Reg. 15A.453-1(b)(2)(iv) Is Not Applicable: The full $70,000 mortgage assumption is not a payment. Here, there are no other payments.
NO Payments x 40 % (GP ratio) = NO taxable gain.

Total Tax Impact = NONE. NO taxes due.

Total Cash Impact = NONE. NO negative cash impact.

STRATEGIES:

Strategy 1: Document that the debt was incurred before deciding to sell the property. Then the debt should not be considered to be in “contemplation of disposition of the property” and therefore not be considered a payment. Such documentation as a Realtor listing agreement (and any other documents about selling the property), should be dated after any loan documents. In other words, the loan documents should be dated before the Realtor listing agreement (and any other documents about selling the property). Again, this provision is subject to controversy.

Strategy 2: Follow the same planning recommendations as before: (1) Obtain more of a cash down payment to cover all of the taxes; (2) Have the buyer be legally liable to directly pay seller transaction costs. (3) Look for tax losses or deductions to reduce taxable gain, such selling a loser stock or retirement plan contribution.

8. PAYMENT 8: Excess-of-debt-over-basis, if the debt is directly assumed (or taken subject to) by the buyer [Reg. 15A.453-1(b)(3)(i)]. Wrap-around mortgage.

If the buyer directly assumes or takes subject any mortgage debt and other related debts* in excess of the property’s adjusted basis, then the excess is considered an initial cash payment (even though it is not received as cash)
*ALERT: Here, “debt” includes obligations other than the mortgage, such as back taxes or mortgage interest in arrears assumed by the buyer. If any of these obligations are assumed by the buyer, then they are considered part of property debt and if such debt exceeds the property’s basis, the excess is income, Reg. 15A.453-1(b)(2)(iv)

**TAX BREAK:** Selling expenses reduce excess-of-debt-over-basis. Under the general rules for installment sale, basis includes commissions and other selling expenses. While this still has the same bottom line effect in reducing the total gross profit, it makes a difference in this scenario, because it will reduce the amount of excess-of-debt-over-basis.

In this scenario, excess-of-debt-over-basis has two adverse tax consequences:

1. The excess is considered an initial cash payment, triggering taxation of **phantom gain** in the year of sale.

2. The excess is added to the contract price, which **always results in a 100% gross profit ratio**, causing ALL of the installment gain to be taxed.

**NOTE:** Debt-in-excess-of-basis is more common than you may think!
*Reason:* Each year depreciation deductions causes your basis to go down. When you refinance the property, your debt goes up. As previously discussed, there could also be other debt assumed, such as back taxes or mortgage interest in arrears. This too causes your debt to go up. The combination of your basis going down via depreciation, and debt going up via more debt, can quickly create the nemesis of excess-of-debt-over-basis.

(**Reminder:** This taxable event does not occur merely with the presence of debt-in-excess of basis. It happens when there is a sale with seller financing, installment sale reporting is elected and the buyer assumes or takes subject to any property debt.)
EXAMPLE 10: Taxpayer is selling non-dealer property with the following data:

**Income Tax Data:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$110,000</td>
</tr>
<tr>
<td>Basis</td>
<td>50,000</td>
</tr>
<tr>
<td>+ Selling expenses</td>
<td>+10,000</td>
</tr>
<tr>
<td>(commission)</td>
<td></td>
</tr>
<tr>
<td>= Total adjusted basis</td>
<td>- 60,000</td>
</tr>
<tr>
<td>Gross profit (or realized gain)</td>
<td>= 50,000</td>
</tr>
<tr>
<td>Depreciation recapture</td>
<td>none</td>
</tr>
</tbody>
</table>

**Terms of Sale:**

- Buyer’s cash down payment: $10,000
- Seller takeback (installment sale): $20,000 (second mortgage)
- Existing debt to be assumed: $80,000
- = Total selling price: $110,000

**Payments Received:**

- Down payment: $10,000 (actual cash)
- Principal pmts during the year: $500 (actual cash)
- Excess-of-debt-over-basis*: $20,000 (phantom income)

- = Total payments rec’d for the year: $30,500

- Gross profit (or realized gain): $50,000
- Contract price: $50,000** ($110,000 - 80,000 + 30,000)

**Gross profit ratio**: 100%

(**Contract price of $50,000 is the total selling price of $110,000 less the assumed mortgage of $80,000 plus the mortgage-in-excess-of-basis of $20,000**)

**The Taxable Gain Is High At $30,500:**
ALL of the cash received is taxed as follows:

\[ \$30,500 \text{ (Payments)} \times 100\% \text{ (GP ratio)} = \$30,500 \text{, the recognized or taxable gain.} \]

**Total Tax Impact:** Assuming a 20% rate, the tax liability on the \$30,500 is \$6,100.

**Total Negative Cash Impact:** The end result is that the seller would have to come up with \$5,600 out of their pocket to pay the taxes, which is the total actual cash received of \$10,500, less \$10,000 selling expenses, less \$6,100 taxes.

**STRATEGIES FOR EXCESS-OF-DEBT-OVER-BASIS:**

**Strategy 1:** To prevent this tax disaster from happening, do a wraparound mortgage. A *wraparound mortgage* will consist of at least two mortgages wrapped into one. The first mortgage will be the existing underlying first mortgage where the seller will continue to make the payments after the property is sold. Thus, this mortgage is not paid off at the settlement. The second mortgage will be a junior mortgage held by the seller for all or part of their equity in the property. The seller “wraps” the first and junior mortgages into one *all-inclusive* or *wraparound* mortgage. Instead of the buyer making two separate payments to two separate lenders, the buyer will make one payment to the seller. The seller in turn will continue to make payments on the first mortgage and pocket the difference on their second mortgage. So, **with a wrap-around mortgage, the underlying existing mortgage is not paid off, is not assumed or taken subject to by the buyer. It stays with the seller (the former property owner).**

**Tax Result:** Because the existing mortgage is not considered to be directly assumed (or taken subject to) by the buyer, the above two adverse tax
consequences will be improved in that the excess-of-debt-over-basis will *not* be a payment and there will be a lower gross profit ratio. This is illustrated in Example 11.

**ALERT ON IRS POSITION VS. TAX COURT’S:** In their 1981 proposed regulations the IRS still considers debt-in-excess-of-basis to be a payment, even with a wrap mortgage, Reg. 15A.453-1(b)(3)(ii). However, the tax courts* have consistently overruled the IRS position and have considered their regulations to be invalid (which they should be). [*See Stonecrest, 24 TC 659 and Hunt, 80 TC 1126.]* Accordingly, this prior case law should be controlling, (even though the IRS has not yet revised the above regulation). Moreover, the IRS did finally acquiesce to a decision where, because of the use of a wrap mortgage, the existing debt was *not* considered to be directly assumed by the buyer. *Professional Equities, Inc.,* 89 TC 165 (1989), Acq.1988-37 IRS 4.

**EXAMPLE 11 - WRAP:** Same facts as the previous example, except instead of having the buyer directly assume the existing mortgage of $80,000 with a separate second mortgage of $20,000, the seller wraps these debts into one wrap mortgage of $100,000. Instead of the buyer making two separate payments to two separate mortgagees, they will make *one* payment to the seller. (The seller in turn will continue to make payments on the first mortgage and pocket the difference on their second mortgage.) *With the wrap, the $80,000 existing mortgage is not considered to be directly assumed by the buyer.*

**Positive Tax Result:** Much better than the above adverse tax results:

1. The excess of mortgage-over-basis is *not* considered an initial cash payment. Thus, there is no taxation of phantom gain on this portion.

2. The excess is *not* added to the contract price, resulting in a much lower gross profit ratio, causing less of the gain to be taxed.
Below is the revised wrap mortgage data with the positive changes in bold:

**Terms of Sale:**

Buyer’s cash down payment    $ 10,000  
Seller wrap mortgage        100,000 ($80,000 existing mtg. + 20,000 2nd)  
Existing debt to be assumed   none  
= TOTAL selling price        $110,000

**Payments Received:**

Down payment      $ 10,000 (actual cash)  
Principal pmts during the year 500 (actual cash)  
Excess-of-debt-over-basis     0 (not considered a cash payment)  
Total payments rec’d for the year $ 10,500 (actual cash)

Gross profit     $ 50,000 (same as before)  
Contract price    $110,000 (total selling price, without adjs.)  
Gross profit ratio 45%

**The Taxable Gain Is Now Only $4,725:**

When the $50,000 gross profit is divided by the higher $110,000 contract price, the result is now a lower 45% gross profit ratio. Moreover, the total payments received is reduced to $10,500 (instead of $40,500).

$10,500 (Payments) x 45 % (GP ratio) = $4,725, the recognized or taxable gain.

**Total Tax Impact (is much lower):** Moreover, this taxable gain of $4,725 is cash income. Assuming a 20% federal capital gain rate, the tax liability on the $4,725 is $945 (instead of $6,100).

**Total Cash Impact (is much improved):** The end result is that the seller would have to come up with only $445 (instead of $5,600) out of their pocket to pay the
taxes, which is the total actual cash received of $10,500, less $10,000 selling expenses, less $945 taxes.

**Strategy 2:** Obtain more of a cash down payment to cover all of the taxes, as previously discussed in this section.

**Strategy 3:** Have the buyer be legally liable to directly pay the $10,000 Realtor commission. For a further discussion of this, see Strategy 2 under Payment 9, previously discussed in this section.

**NOTE:** Same Tax Consequences With An *Installment Land Contract* Which Often Involves Wrap Mortgages. An *installment land contract* conveys “equitable ownership” in a property from the seller to the buyer. Under this arrangement the buyer promises to pay the seller the debt specified in the contract. Until the debt is paid (or other obligations are fulfilled), the seller retains legal title to the property as security for payment of the purchase price. During the term of the contract the buyer has equitable ownership, which means that they control the property in that they can rent or sell it, just the same as if they had legal title. They are also totally responsible for taxes, insurance and the upkeep of the property. The deed could be escrowed with an independent party. (An *Installment land contract* is also called a “land contract”, “installment contract”, “contract for deed”, “agreement for deed”, “articles” and sometimes a “lease-purchase”.)

**An Installment Land Contract Is A Completed Purchase & Sale For Tax Purposes:** It is well established in tax law* that legal title does not have to pass to have a completed purchase and sale. [*Fred White, TC Memo 1974-69; Union Pacific R.R. Co. (1936, CA2) 86 F2d 637, 18; Ted Merrill (1936) 40 TC 66. Many other cases can be cited].

*Consequences To Buyer:* Because the buyer has the “burdens & benefits” of equitable ownership, they are entitled to the tax benefits of ownership such as
depreciation and other property expense deductions. See Section 9 for a further discussion.

*Tax Consequences To Seller:* The seller has a completed sale which is a taxable event. However a non-dealer seller is entitled to defer capital gain’s tax via installment sale reporting. Generally, installment land contracts are structured as wrap mortgages, (except legal title does not pass). Accordingly, the seller could have the favorable tax advantages of wraps, as discussed above.

**LEGAL TIP:** The parties should adhere to certain legal safeguards with installment land contracts. A competent real estate attorney should be engaged. Even better check out PrePaid Legal for a low monthly cost. Visit [www.prepaidlegal.com/hub/janinepratt](http://www.prepaidlegal.com/hub/janinepratt) or call 215-271-1998.

**C. STRATEGY: ELIMINATE INSTALLMENT SALE REPORTING (AND THE ABOVE TAXABLE PHANTOM INCOME) WITH OTHER STRATEGIES**

There are strategies to eliminate installment sale reporting altogether and therefore eliminate the above types of phantom income and other related traps discussed in the ensuing sections. Strategies are discussed in Chapter 39-B.

**D. TAX ALERT ON ESCROW ARRANGEMENTS**
Sometimes the buyer\borrower, or the seller, wants to eliminate the property as security for the debt. To do this, the buyer\borrower substitutes the security by depositing cash (or cash equivalents) with an escrow agent sufficient to pay the installment payments (with interest) in consideration for the seller’s release of the security. If the escrow agreement does not provide for a letter of credit or substantial restrictions on the right to receive future escrows, this substitution of escrow will mostly likely be a constructive taxable payment of the installment obligation balance. Result: The termination of installment sale reporting and full taxation, Reg.15A.453-1(b)(5). For a further discussion of escrow arrangements, see Appendix D, part 4.

Reference Source (return tab): SAP 26, Part B

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Phantom income is income that is fully taxed even though no cash is received. Without prior knowledge and advanced planning, it can be a costly tax trap for the unwary or ill advised taxpayer. In the ensuing discussion planning tips will be given. The following installment sale traps will result in this nemesis known as phantom income.

**TRAP 1: SALES OF DEALER PROPERTY DO NOT QUALIFY FOR TAX DEFERRAL VIA INSTALLMENT SALES**

**TRAP 2: ORDINARY INCOME FROM DEPRECIATION RECAPTURE (SECTIONS 1250 AND 1245)**

**TRAP 1: SALES OF DEALER PROPERTY DO NOT QUALIFY FOR TAX DEFERRAL VIA INSTALLMENT SALES**

As with 1031 exchanges, tax deferral via installment sale reporting is *not* permitted for dealer dispositions, IRC 453(b)(2)(A).

(*Note: For simplicity purposes, the ensuing examples will assume a 20% federal and state capital gain rate, and a rounded 40% ordinary income tax rate.*)
**EXAMPLE 1**: ID sells a property for $150,000. Assume the property basis is $100,000. The realized gain is $50,000 (150,000 less $100,000). In the first year the buyer puts down $21,000 and ID will hold back as seller financing the remaining $129,000. (In this first year assume the buyer makes no other principal payments.)

**A. As an Investor**: ID can defer part of the gain with installment sale reporting under IRC 453. Using installment sale, ID’s gross profit ratio is 33-1/3% or the $50,000 gain over the contract selling price of $150,000. In the first year, ID’s taxable gain is $ 7,000 or 33-1/3% of the $21,000 cash down payment. With a 20% capital gain rate, ID owes $4,200 in taxes.

**B. As a Dealer**: ID is *not* entitled to installment sale reporting and therefore must pay tax on the entire $50,000 gain, even though ID received only a small portion of the price in cash. Assuming a top ordinary income rate of 40%, ID would owe $20,000 in taxes on the entire $50,000 gain. The $21,000 down payment will almost all go to taxes, instead of ID’s pocket. If ID had to pay a commission out of the $21,000, he would have to dig in his own pocket to pay the taxes.

**TAX BREAK**: Dealer Sales of Residential Lots and Timeshares May Qualify For Installment Sale Reporting (But at a Cost). As per IRC 453(l)(2)(B), installment sale is permitted for the following three types of dealer sales to individuals:

1. Residential lots, provided that the taxpayer (or any related person) does not make any improvements to the lots.

2. Timeshare-rights to use, or timeshare ownership-interests in residential real property for not more than 6 weeks a year.
(3) Rights to use specified campgrounds for recreational purposes.

**ALERT:** There is a cost for the above relief provision. The above relief provision is allowed, only if the taxpayer pays the IRS a certain amount of interest on the deferred tax liability from installment sale reporting, IRC 453(l)(3)(A). The interest is calculated at the applicable federal rate (AFR) in effect at the time of sale (compounded semiannually) and is payable with the tax due for each year gain is taxed on the installment obligation, IRC 453(l)(3)(B). If there are no payments, there is no taxable gain and no tax due. In this situation, then no interest is due, PLR 9133002. Any interest that is paid is deductible, IRC 453(l)(3)(C).

**Strategy:** Follow the Goldmine strategies to totally avoid dealer status. See Chapters 6, 41, 42 and 43-A. By not being a dealer, when you do give seller financing, you are then entitled to the tax deferral via installment sale reporting.

**TRAP 2: ORDINARY INCOME FROM DEPRECIATION RECAPTURE (SECTIONS 1250 AND 1245)**

Unlike a 1031 exchange, installment sale does not defer any depreciation recapture. Such recapture is recognized in full as ordinary income in the year of disposition, IRC 453(i). “Depreciation Recapture” is certain additional depreciation from the sale of real property (IRC 1250) or personal property (IRC 1245). With real property, it generally results from holding a property for less than a year or taking an accelerated depreciation method. With personal property, it results from using any depreciation method. If non-residential real estate was placed in service from January 1, 1981 to December 31, 1986 and the accelerated method was elected, **ALL** of the accumulated depreciation is subject to recapture, fully taxed as ordinary income, (none of which can be deferred with installment sale). IRC 1245(a)(3)(A); 1250(c)].
Depreciation recapture is further discussed in Chapter 30-A. The important point here is that installment sale reporting will not defer any part of the realized gain (gross profit) that pertains to accelerated depreciation recapture. You must recognize the entire recapture gain and pay the resultant tax liability, even if you receive no initial cash payments, IRC 453(i). Depreciation recapture is phantom income, which is fully taxed even though no cash is received. This is a nasty trap for the unwary taxpayer.

**EXAMPLE 2:** Taxpayer is selling non-dealer property with the following data:

**Income Tax Data:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selling price</td>
<td>$100,000</td>
</tr>
<tr>
<td>Adjusted basis</td>
<td>-30,000</td>
</tr>
<tr>
<td>Selling expenses</td>
<td>-10,000</td>
</tr>
<tr>
<td>Gross profit (or realized gain)</td>
<td>= 60,000</td>
</tr>
<tr>
<td><strong>Depreciation recapture</strong></td>
<td><strong>$12,000</strong></td>
</tr>
</tbody>
</table>

(Fully taxable as ordinary income)

**Terms of Sale:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seller takeback (installment sale)</td>
<td>$90,000</td>
</tr>
<tr>
<td>Buyer’s cash down payment</td>
<td>$10,000</td>
</tr>
<tr>
<td>Existing debt to be assumed</td>
<td>none</td>
</tr>
<tr>
<td><strong>Total Selling Price</strong></td>
<td><strong>$100,000</strong></td>
</tr>
</tbody>
</table>

**Payments Received:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Down payment</td>
<td>$10,000</td>
</tr>
<tr>
<td>Principal pmts during the year</td>
<td>none the first year</td>
</tr>
<tr>
<td>Total payments rec’d for the year</td>
<td>$10,000</td>
</tr>
<tr>
<td>Gross profit (or realized gain)</td>
<td>$60,000</td>
</tr>
<tr>
<td>Contract price</td>
<td>$100,000</td>
</tr>
</tbody>
</table>

**The Taxable Gain Is Computed In Two Parts:**
(1) Of the $60,000 gross profit, there is **depreciation recapture of $12,000, fully taxed as ordinary income**. Assuming a 40% (rounded ordinary income rate), the **tax liability on the $12,000 is $4,800**.

(2) The remaining gross profit is capital gain. The $12,000 depreciation recapture is subtracted from the original gross profit for purposes of determining the gross profit ratio and the portion of the remaining gain to be recognized from each payment.

\[
\begin{align*}
\text{Gross profit (or realized gain)} & = $60,000 \\
\text{Less: Depreciation recapture} & - 12,000 \\
\text{= Adjusted gross profit for GP ratio} & = $48,000
\end{align*}
\]

The recognized (capital gain) under the installment sale for the first year is:

The adjusted gross profit of $48,000 divided by the contract price of $100,000 = a gross profit ratio of 48%. Next, $10,000 (Payments) \times 48\% \text{ (GP ratio)} = $4,800, the recognized or taxable gain. Assuming a 20% federal capital gain rate, the tax liability on the $4,800 (taxable gain) is $960.

**Total Tax Impact:** $5,760 which is $4,800 in taxes on the phantom recapture gain and $960 in taxes on the capital gain.

**Total Negative Cash Impact:** Here, the seller is only receiving in the first year $10,000 cash, less selling expenses of $10,000, equals *nothing* left to pay the total taxes of $5,760. **The seller must painfully fork out $5,760 from their pocket.**

**Strategies For Installment-Sale Depreciation Recapture:**

(1) **Look for tax losses or deductions to reduce taxable gain**, such as selling a loser stock or making a deductible retirement plan contribution.
(2) Obtain more of a cash down payment to cover all of the taxes. See example, next.

**EXAMPLE 3 (Obtaining more of a cash down payment):** Same facts as Example 2, except you reduce the seller takeback by $6,400 and obtain another $6,400 cash down or a total of $16,400 in payments ($10,000 + 6,400). $16,400 (Payments) x 48% (GP ratio) = $7,872, the recognized or taxable gain. Assuming a 20% rate, the capital gain tax liability on the $7,872 is $1,574.

**Total Tax Impact:** $6,374 which is $4,800 in taxes on the phantom recapture gain and $1,574 in taxes on the capital gain.

**Total Cash Impact (is now positive):** With the $16,400 cash less selling expenses of $10,000, equals $6,400 to pay the taxes of $6,374. Now, the seller has net positive cash of $26 in their pocket. (Of course, any more of a down payment would increase this.)

(3) Instead of seller financing via installment sale, sell for cash via a 1031 exchange. **Reason:** A 1031 exchange can totally avoid all tax liabilities on the sale of real estate, including depreciation recapture. Why sell for cash via 1031? Seller-held notes do not qualify for a 1031 exchange, but cash does. However, at least to some degree, it is possible to combine seller financing with a 1031 exchange. For a further discussion, see Chapter 39-B and Section VIII-19 of *The 1031 Money Machine*.

**TRAP 3: INSTALLMENT SALES WITH RELATED PARTIES** – See the next chapter.
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Installment Sales With Related Parties
Another Potential Costly Tax Trap

Reference Source (return tab): SAP 26, Part D

There are two types of related party provisions as follows:

1. FIRST IS THE SALE OF ANY PROPERTY (DEPRECIABLE OR NOT DEPRECIABLE) TO CERTAIN RELATED PARTIES

2. THE SECOND RELATED PARTY RESTRICTION INVOLVES SALES OF DEPRECIABLE PROPERTY TO CERTAIN RELATED (CONTROLLED) ENTITIES, SUCH AS A CORPORATION, PARTNERSHIP, LLC OR TRUST

1. THE SALE OF ANY PROPERTY (DEPRECIABLE AND NOT DEPRECIABLE) TO CERTAIN RELATED PARTIES (DEFINED BELOW).

Here, installment sale is available upon the initial sale to the related party. However, all or part of the gain on the installment sale may be accelerated when and if the “related” buyer resells the property within two years of purchasing the property, and if upon this sale, more cash (and other property) flows into the “related group” as a result of the second disposition of the property, IRC 453(e); IRC 453(f). In other words, the additional gain that is taxed - is the excess of the
payments from the second disposition over the actual payments from the first installment sale disposition

**NOTE:** The above provision does not prevent deferring gain via installment sale between the related parties (listed below). It only becomes applicable when the related-party buyer subsequently sells the property and more cash flows to the related group (as per the above). Here, the second disposition may accelerate part or all of the deferred gain in the first disposition. See Example 1, below.

**A. The following are “related parties” for the above rule:**

Under IRC 267(b) “related parties” include spouses, parents, grandparents, children, grandchildren, and more than 50% (51% or more) owned entities such as corporations, LLC’s, partnerships, trusts, etc. Corporations, LLC’s, partnerships, trusts, and estates are related parties to a person under the general attribution rules of corporate stock ownership, IRC 453(f).

**B. However, the following are not “related parties” for the above rule:**

Aunts, uncles, cousins, nieces, nephews, X-wives, X-husbands, business associates, close accommodating friends and a 50% or lower ownership in one of the above entities. Also, brothers and sisters are not related parties for the purpose of these rules, and probably not in-laws.

**EXAMPLE 1 - WITHOUT THIS PROVISION:** RJ receives a $130,000 all cash offer on her rental property. With selling expenses of $10,000, the net selling price is $120,000 and with an adjusted basis of $20,000, the realized gain is $100,000. The property is owned free and clear of any mortgages and therefore the net equity is $120,000 before taxes. With a realized gain of $100,000 and an assumed (rounded) 30% tax bracket, the tax liability on an outright cash sale would be $30,000, resulting in an after-tax equity of $90,000 ($120,000 less the
taxes of $30,000). To prevent the tax drain, RJ sells the property to her son, JR (a related party), for $130,000 with a 100% seller financing and payments to begin 10 years after the date of closing. JR immediately sells the property, all cash, to a third party buyer.

*Tax Result Without Restriction:* Because JR’s basis in the property is the purchase price of $130,000, JR has no taxable gain on his cash sale to the buyer. RJ has no taxable gain on the first sale to JR, because of a 100% installment sale reporting. RJ would not have any taxable gain until JR starts to make installment payments on the seller takeback, 10 years later. In the meantime, the family has the entire net equity of $120,000 as tax-free money that they could use to enjoy life and invest to accumulate more wealth.

*Tax Result With Restriction:* Unfortunately, IRC 453(e) prevents the above tax deferral strategy. Under this provision, in the above example RJ would be fully taxed on the $100,000 gain upon the second disposition from JR to the cash buyer. *Reason:* RJ sold the property within two years of the first disposition.

**Strategies For This First Related Party Rule:**

**Strategy 1:** Have the related party wait the two years and then sell for cash. However, you have to consider the practicality of this. Will a readily available buyer wait two years? The buyer could “control” the property immediately with a two-year *sandwich lease*. With this type of lease the buyer has the right to sublet the property and an option to buy it. Alternatively, the buyer can just have an option to buy the property in two years.

**TAX ALERT:** The law attempts to put a blockade on doing the above “buyer control” devices. Any arrangement which substantially diminishes the risk of ownership during the two-year period will accelerate the installment gain as per the above. Included here is the granting of a put or option giving another
person (namely a buyer) the right to acquire the property. Also included is a short sale or any other transaction, IRC 453(e)(2)(B).

**TAX BREAK:** However the holding of an option will not come within this restriction, provided that the purchase price is to be determined by the fair market value at the time the option is exercised. S Rept. No. 96-1000, p.15, PL 96-471, 10/19/80. Also, a typical close corporation shareholders’ agreement is not intended to come within this restriction. Does the latter also mean that a “typical” sales agreement to purchase the property (after the two years) is to be excluded from this restriction? Here, we would need more clarity.

**STRATEGY:** Give the buyer an option where the purchase price is to be determined by the fair market value at the time the option is exercised. Another arrangement that should work is a pure lease with a “right of first refusal”, giving the lessee the first right to buy the property if it is offered for sale (provided that the purchase price is to be determined by the fair market value at the time the option is exercised). Make sure that either arrangement does not give the buyer any legal or equitable ownership in the property. Seek legal counsel as to what gives, and what does not give, “equitable” ownership in your locale. See Chapter 9, Part G for a discussion of “equitable” ownership.

**Strategy 2:** Sell to an unrelated, but “friendly” party, such as those listed in Paragraph B above.

**ALERT:** These unrelated party sales are not subject to any technical related party rules. However, the Senate Finance Committee Report of the Installment Sales Revision Act of 1980 did address the close scrutiny of “transactions that are shams” (S. Rept No. 96-1000, p.16, 17 PL 96-471, 10/19/80). Accordingly, the validity of such sales should be at an arms-length selling price and terms, backed up by comparable sales or appraisal. All parties should be legally bound with the same documents (agreements, disclosures, etc.) that are used in arm’s length real estate transactions. Consult with competent real estate counsel.
Strategy 3: Come under one of the exceptions that permit such related party installment sales. Gain is not accelerated upon the second disposition if:

(1) The second disposition is because of an involuntary conversion per IRC 1033 and the first disposition occurred before the threat of the conversion. IRC 453(e)(6)(B). (For a further discussion of involuntary conversion, see Chapter 31 and IRS Pub. 544)

(2) The second disposition occurs after the death of the seller or the related buyer. IRC 453(e)(6)(C). (Comment: I would not rush this one!)

(3) It can be established to the satisfaction of the Secretary of Treasury that neither the first disposition nor the second disposition was not to avoid paying federal income taxes. IRC 453(e)(7).

**NOTE**: Apparently, the taxpayer must file the reason(s) for coming under this third exception with the National IRS Office in Washington, DC. This is generally a tough exception to come under. However, the Senate Finance Committee Report* has given some specific guidance as to what situations may qualify, such as where the second disposition is beyond the control of the taxpayer (as with a foreclosure or bankruptcy). These are not considered to be tax motivated. The same holds true if the terms of payment of the second disposition are substantially equal or longer than the terms of the first disposition. Other non-tax motivated transactions on the second disposition are tax free transfers such as 1031 exchanges, charitable transfers, gift transfers and transfers to a controlled corporation or partnership. (*S. Rept No. 96-1000, p.16 PL 96-471, 10/19/80.)

Strategy 4: For the related buyer consider a “diluted C-corporation”. For more about this email use with your VIP code.
**Strategy 5**: Avoid installment sale altogether and do a 1031 tax-free exchange. Having an all-cash buyer, along with no or little seller financing, is favorable for a 1031 exchange. For a further discussion of this strategy, see Chapter 39-B of this publication.

**2. THE SECOND RELATED PARTY RESTRICTION INVOLVES SALES OF DEPRECIABLE PROPERTY TO CERTAIN RELATED (CONTROLLED) ENTITIES, SUCH AS A CORPORATION, PARTNERSHIP OR TRUST (DEFINED BELOW).**

Here the entire gain is triggered on the initial sale as installment sale reporting is not available at all. IRC 453(g)(1)(A). (There is no second disposition.) The reason for this provision is to prevent a sale to certain related entities (such as a corporation or partnership) that would start depreciating the higher market value basis without the concurrent reporting of income by the seller. IRC 453(g)(1)(B).

**NOTE**: The property must be “depreciable”. Accordingly, non-depreciable property, such as land, does not come under this restriction, although it may come under the first related party restriction of this section. Depreciable property means property depreciable to the buyer in accordance with IRC 167, IRC 453(f)(7).

**A. For the purposes of this provision [IRC 453(g)(3)] related entities are:**
(1) A corporation, LLC or partnership in which the taxpayer\seller* has a more than 50% ownership interest.

(2) Two or more partnerships in which the same taxpayer* owns a more than 50% capital or profit interest. (Presumably LLC-partnerships are included here) //

(3) Any trust in which this taxpayer* (or their spouse) is a beneficiary. IRC 1239(b) and IRC 707(b)(1)(B).

*ALERT: The above taxpayer’s ownership also includes the taxpayer’s family such as spouses, brothers, sisters, ancestors and lineal descendants. IRC 1239(c)(2). So if a taxpayer owned 49% of a corporate entity and his or her family owned the other 51%, the taxpayer is deemed to own 100% (more than 50%); and would therefore be subject to these related party restrictions.

B. One exception where such related party rules can qualify for installment sale:

If can be established to the satisfaction of the Secretary of Treasury that the disposition was not to avoid paying federal income taxes. IRC 453(g)(2). Here, the best (and perhaps the only) reason that may work is a substantial lack of tax deferral.

For further details, with examples, see IRS Publication 537.

Reference Source (return tab): SAP 26, Part D

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval
system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Selling or Disposing The “Paper” -- Tax Impact, Related Traps, Planning

Reference Source (return tab): SAP 26A

Subsequent to electing tax deferral via installment sale reporting, if an installment note (“paper”) is sold, distributed, transmitted or otherwise disposed of, there will usually be a gain (or possible loss) which is the difference between the amount realized (or the fair market value of the note) and the basis of the note, IRC 453B(b).

Selling the note for cash is one obvious method of disposition that can result in a taxable gain. However, other forms of disposition, such as gifting, canceling, exchanging or pledging the note can also result in taxable gain. However, in these types of note dispositions, the gain is our old nemesis - phantom income (taxable gain without cash).

On the other hand, transfers between spouses do not trigger the taxable gain. Save for one exception, transfers because of death also do not trigger the taxable gain.

[NOTE: The taxable events (discussed in this chapter) will only happen when the deferral of gain of installment sale reporting is elected. If the taxpayer elects out of installment sale and fully reports the entire gain in the year of sale, then there will be no gain on the sale, transfer or disposition of the note if the note is sold for an amount that is equal to or less than its face value.]
value. In fact, there will be a loss, if the note is sold at a discount for less than its face value (which is the usual case).

[See Chapter 39-A on making the decision of to elect, or not to elect installment sale. See Chapter 35 on how to elect out of installment sale.]

The above (probable loss on note sale) would also hold true if you purchased the note in a separate transaction, instead if the note being part of paper you took back.

The following different forms of disposition are under the assumption that the taxpayer has elected the tax deferral provisions of installment sale under IRC 453.

1. SELLING THE ENTIRE NOTE FOR CASH

2. SELLING PART OF THE NOTE FOR CASH

3. FULL SATISFACTION OF THE INSTALLMENT NOTE BEFORE MATURITY OR A FINAL BALLOON PAYMENT

4. GIFTING THE INSTALLMENT NOTE (ANY GAIN = PHANTOM INCOME)

5. INSTALLMENT NOTE OBLIGATIONS THAT ARE CANCELED, FORGIVEN OR UNENFORCEABLE ARE ALSO TAXABLE PHANTOM DISPOSITIONS

6. EXCHANGING THE NOTE IS A TAXABLE PHANTOM DISPOSITION

7. USING THE NOTE AS A DOWN PAYMENT IS A TAXABLE PHANTOM DISPOSITION

8. PLEDGED INSTALLMENT NOTES AS COLLATERAL FOR A LOAN, IF THE SELLING PRICE OF THE PROPERTY EXCEEDS $150,000

9. A TRANSFER OF THE INSTALLMENT NOTE BETWEEN SPOUSES OR INCIDENT TO A DIVORCE AS PER IRC 1041 (not taxable)
10. A TRANSFER OF THE INSTALLMENT NOTE UPON DEATH (does not accelerate gain save for one exception)

1. SELLING THE ENTIRE NOTE FOR CASH: After taking back a mortgage and (electing installment sale) many investors will then sell the “paper” to generate cash. The sale will result in a taxable gain or loss, IRC 453B(a), Reg. 1.453-9. The gain or loss is computed like any other sale -- the total selling price, less selling expenses = the amount realized, less the basis of the note = the gain or loss, IRC 453Ba); Reg. 1.453-9(b). The basis of the note is the face value of the note, less the income that would have been reported if the note were satisfied in full (which is the total gross profit less any taxable gain previously reported). IRC 453B(b); Reg. 1.453-9(b)(2).

EXAMPLE 1: Refer to Example 1 of Chapter 35, where there was a contract selling price of $100,000, a gross profit of $60,000 and therefore a gross profit ratio of 60%. In this example the buyer had already made first-year payments of $30,478.

Selling price of the note is $60,000. Before the buyer makes any more payments, you sell the $70,000 installment note for a discounted cash price of $60,000. Assume there are no selling expenses (the buyer pays the fees for the note\mortgage preparation, etc.).

The basis of the note is $28,287, as follows: In this example the buyer had already made first-year payments of $30,478 resulting in a taxable gain of $18,287 ($30,478 x 60%). Therefore, the income that would have been reported if the note were satisfied in full is $41,713, which is the total gross profit of $60,000 less the taxable gain already reported - $18,287. The basis of the note is $28,287, which is the face value of the note - $70,000, less the income that would have been reported if the note were satisfied in full - $41,713.
The gain on the note sale is $31,713 ($60,000 selling price, less 28,287 basis)

Proof: The above gain of $31,713 plus the $18,287 gain already reported equals a total taxable gain of $50,000, which is the total gross profit of $60,000, less the $10,000 discount on the sale of the note. That is, the $50,000 amount is the maximum amount of gain that could be taxed in this example. In other words, discounting the note by $10,000 is the same as selling the property for $90,000 with a gross profit of $50,000 (instead of a selling price of $100,000 with a gross profit of $60,000).

NOTE: The character of the gains and losses on note sales will be the same as the underlying real estate, IRC 453B(a). As discussed in Chapter 35, installment sale reporting defers capital gains, but not ordinary income from depreciation recapture. Because of this, the character of the gains and losses on note sales will be capital.

2. SELLING PART OF THE NOTE FOR CASH: Investing in “paper” renders the opportunity for numerous creative strategies. One of them to is to sell part of a note, instead of all of it. Again, your gain or loss will be the difference between the net selling price of the note and the basis of the note. Here, you would first calculate the entire basis of the note and then pro-rate this basis based on what percentage of the note was sold.

EXAMPLE 2: Same facts as the above example, except you sell one-tenth or $7,000 of the $70,000 note for $6,200, which becomes the selling price. The basis of the note is $2,829, which is one-tenth of the entire basis of $28,287 in the previous example.

The gain on the note sale is $3,371 ($6,200 selling price, less 2,829 basis)
Sometimes selling part of a note takes the form of selling a certain number of payments, such as the next 12 or 24 payments.

**EXAMPLE 3:** In our original example from Chapter 35, the monthly payment on the note is $563.24 with a face amount of $70,000, 9%, 30 years. Same facts as the original example, except after the first year, you sell the second calendar year’s 12 payments for $5,900. In other words, for the next 12 months your note buyer will receive the payments; you will not. After the 12 months, you will again start to receive the payments. The **selling price is $5,900** (that’s the easy part of the computation). For the basis of the payments sold, you have to do the following computations:

(a) Again compute the entire basis as if you sold the entire note, which is $28,287.

(b) Using a financial calculator or computer amortization program, figure out the principal portion of the second year’s 12 payments sold, which is $523 (rounded).

(c) Divide the amount in (b) by the total face amount of the note to arrive at the percentage for pro-rating the entire basis. $523/$70,000 = .75% or .0075

(d) Compute the basis by multiplying the amount in (c) by the total basis in (a). $28,287 x .0075 = **$212, the basis of the payments sold.**

**The gain on the note sale is $5,688** ($5,900 selling price, less the $212 basis). [Comment: “Paper” can be a lucrative business.]

**NOTE 1:** While the seller will have to report the above gain, they do not have to report the interest income for that year as they did not receive the payments.
NOTE 2: With these partial sales, some aggressive tax planners may experiment with more favorable basis allocations for the seller. For example, some may argue that a larger amount of basis should be allocated on the earlier partial sales based on a higher fair market value of the note. (Such larger allocations would lower the gain on the earlier sales, while gains on later sales would be higher.) IRS regulations do not specifically cover such partial sales. Installment sales with contingent selling prices have a provision where the taxpayer may use an alternate method of basis recovery if the taxpayer can demonstrate that the application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis (and therefore accelerate taxable income). With this exception, the taxpayer may be able to further defer taxable income from an installment sale with a contingent selling price. For a further discussion of these complex rules, see Appendix D and Reg. 15A.453-1(c)(7). Despite this, it appears that the allocation in the above example is the correct way, because it’s still based on Reg. 1.453-9(b). But new precedents are set by those who are not afraid to venture into uncharted territory.

3. FULL SATISFACTION OF THE INSTALLMENT NOTE BEFORE MATURITY OR A FINAL BALLOON PAYMENT:

EXAMPLE 4: Refer to Example 1 of Section 35 where there was a contract selling price of $100,000, a gross profit of $60,000 and therefore a gross profit ratio of 60%. In our original example, the monthly payment on the note is $563.24 with a face amount of $70,000, 9%, 30 years with a 5-year balloon. In real estate finance, a “balloon” payment is the final lump-sum principal amount that is paid before the payment term of the loan. For instance, the payments on this mortgage are based on a 30 year term, but the final payoff of the loan is a “balloon” which must be made at the end of the 5 years. Assume at the end of the 5 years, the buyer fulfills their obligation and pays the final balloon payment, which is $67,116 (rounded). The taxable gain in the year of the payoff is $40,270 (60% x $67,116).
**ALERT:** The above early payoff does not qualify for a 1031 exchange.
*Reason:* There is no disposition of like-kind property. A note or mortgage is not like-kind property.

**TAX PLANNING STRATEGIES FOR NUMBERS 1, 2 AND 3:**

**Strategy 1:** Try to postpone any sales, disposition, or earlier payoffs until the beginning of the next tax year. “Deferral” = sooner is better than later! It is true that the taxes are only deferred and not eliminated. However, when you receive the cash in January of the following year, you do not have to pay the deferred taxes until the following April, or a year and three months later (barring any requirements for quarterly estimated taxes). In the meantime, you can generate additional income from the deferred cash income.

**Strategy 2:** Look for tax losses or deductions to reduce taxable gain. For example, any loser stocks that can be sold by year-end will generate capital losses which can be used to fully offset capital gain from the note dispositions. See Chapter 44. A business loss, retirement plan contribution and many other deductions can do the same.

---

**4. GIFTING THE INSTALLMENT NOTE (ANY GAIN = PHANTOM INCOME):** Sometimes, after electing installment sale, the seller gifts the installment-note away. The gift could be to the buyer\borrower as part of a “creative” financing strategy. It could be to a related buyer, or to another party totally unrelated to the transaction, as part of estate planning. Whatever the reason, there could be taxable gain on the gift, IRC 453B(a). Any such gain is phantom income as no cash is received. The amount of gain will be the difference between the fair market value of the note at the time of the gift and the basis of the note. The basis of the note is the same as in the previous example.
EXAMPLE 5: GF sells a property for $100,000 to BJ, an unrelated buyer. Assume the property basis is $40,000. The realized gain (or gross profit) is $60,000 ($100,000 less $40,000). GF elects installment sale reporting. In the first year the buyer puts down $20,000 and GF will hold back as seller financing a first mortgage of $70,000 and a second mortgage of $10,000. The gross profit ratio is 60% ($60,000 gross profit divided by the contract selling price of $100,000).

Gifting the note: Subsequent to this, GF gifts the second mortgage of $10,000 note to the buyer. The fair market value of the note is $8,000 (or 80% of the face value).

The basis of the note is $4,000, computed as follows: In this example the buyer made no payments on this note and therefore no taxable gain had yet been reported. Therefore the income that would have been reported if the note were satisfied in full is $6,000 or the total gross ratio of 60% x $10,000, the principal amount of the note. The basis of the note is $4,000, which is the face value of the note - $10,000, less the income that would have been reported if the note were satisfied in full - $6,000. The gain on the gifted note is $4,000 ($8,000 market value less 4,000 basis).

STRATEGY: Lower the gain by documenting a lower fair market value of the note. The lower the fair market of the note the lower the gain. Typically when a note (or “paper”) is sold in the open market place, the buyer expects a discount. The amount of the note discount (and what a buyer will pay) will depend on several factors: The stated interest rate, the terms of the note, the position of the note (1st, 2nd, etc ), the credit of the buyer\borrower, the history of payments, the buyer’s equity in the property, the quality of the underlying real estate, market\economic conditions, buyer\seller motivations, etc. Thus, the ”market value” for notes could be quite arbitrary and volatile. Consequently, many note investors will pay far less than market, as low as 30 to 50 cents on a dollar.
EXAMPLE 6: In the above example, if GF could document a market value of 60% of the $10,000 face value or $6,000 (instead of $8,000), GF’s gain is lowered to $2,000 ($6,000 market value less 4,000 basis). Moreover, as a second mortgage, 60% of value is within the realm of reality. As far as documentation, a written opinion or estimate from a professional note investor should suffice.

**ALERT:** The above strategy will not work with certain related parties. If the note holder (obligee) and the borrower (obligor) are related parties (defined below), the fair market value of the note will be treated as no less than the face amount of the note, 453B(f)(2). In other words, you cannot discount the face value as per the above. Under these rules, such dispositions will always be fully taxable.

**NOTE:** For the purpose of this rule, the following are “related parties”: Spouses, parents, grandparents, children, grandchildren, and more than 50% owned entities such as corporations, partnerships, trusts, etc. However, the following are not “related parties”: Aunts, uncles, cousins, X-wives, X-husbands, business associates and close, accommodating friends. Also, brothers and sisters are not related parties for the purpose of these rules, and probably not in-laws.

**FOUR STRATEGIES FOR GIFTING AN INSTALLMENT NOTE:**

**Strategy 1:** Sell the note (presumably at a discount) to an unrelated party and then gift the cash to the related party. *Reason:* Your taxable gain will be lower because of the lower discounted price (which is going to mostly likely happen when the note is sold). Plus, the related party probably will be happier with “cold cash”, rather than “paper”.


Strategy 2: Gift the note to one of the above unrelated parties and document a lower fair market value of the note as illustrated in Example 6 above. (Do this provided it meets with your financial goals.)

Strategy 3: Follow the same planning recommendations as before:
(1) Try to postpone any dispositions until the beginning of the next tax year; (2) Look for tax losses or deductions to reduce taxable gain.

Strategy 4: Consider not electing installment sale reporting. See Chapter 39-A on making the decision of to elect, or not to elect installment sale.

5. INSTALLMENT OBLIGATIONS THAT ARE CANCELED, FORGIVEN OR UNENFORCEABLE ARE ALSO TAXABLE PHANTOM DISPOSITIONS: These types of dispositions have the same above tax consequences as gifting, IRC 453B(a); IRC 453B(f); RR 86-72.

STRATEGIES: Follow the same planning recommendations as before: (1) Reduce any phantom gain by documenting as low as a note value as possible (barring any related party rules); (2) Postpone any dispositions until the beginning of the next tax year; (3) Look for tax losses or deductions to reduce taxable gain; (4) Consider not electing installment sale reporting. See Chapter 39-A on making this decision.

6. EXCHANGING THE NOTE IS A TAXABLE PHANTOM DISPOSITION: Instead of selling the note for cash, investors will sometimes exchange the note for another asset such as a property, a car or another note. As with the previously discussed dispositions, this type of disposition will also cause taxable gain or loss, IRC 453B(a). Because a note or mortgage is not like-kind property, its disposition does not qualify for a 1031 tax free exchange. This is so even if the note is exchanged for another note.

EXAMPLE 7: Same facts as Example 5 above, except GF exchanges the $10,000 note for a $10,000 automobile. GF’s gain is $6,000 or $10,000 less the
$4,000 basis. If instead of a car, GF received another note, the same taxable result would occur.

7. USING THE NOTE AS A DOWN PAYMENT IS A TAXABLE PHANTOM DISPOSITION: One “no-money” technique is to use an installment note as a non-cash down payment on a property. Unfortunately, this creative financing idea triggers the taxable gain.

EXAMPLE 8: Same facts as the above example, except GF uses the $10,000 note as a down payment for the purchase of a property. Again, GF’s gain is $6,000 or $10,000 less the $4,000 basis.

STRATEGIES FOR NUMBERS 6 AND 7: Follow the same planning recommendations as before: (1) Postpone any dispositions until the beginning of the next tax year; (2) Look for tax losses or deductions to reduce taxable gain. (3) Consider not electing installment sale reporting. See Chapter 39-A on making this decision.

8. PLEDGED INSTALLMENT NOTES AS COLLATERAL FOR A LOAN, IF THE SELLING PRICE OF THE PROPERTY EXCEEDS $150,000: This is another form of a taxable disposition. As per IRC 453A(d)(1), when an installment note is used as security for a loan, the net proceeds of the secured debt (subject to certain limits) shall be treated as a taxable payment, if all of the following conditions exist:

(1) The selling price of the property securing the installment obligation is in excess of $150,000*, IRC 453A(b)(1).

ALERT: For purposes of the $150,000 cut-off point, all sales or exchanges which are part of the same transaction (or a series of related transactions) shall be treated as one sale or exchange.
(2) The property sold is property used in a business or held for the production of income, IRC 453A(b)(1); IRC 453A(b)(3). (But not farm property)

(3) The payment of principal and interest on the pledged loan is directly secured by the installment obligation, IRC 453A(d)(4).

**Time Of Taxability:** The net proceeds of the secured loan are considered a payment as of the *later* of: (a) The date the debt becomes secured (presumably the date of recording), or (b) the date the loan proceeds of such secured debt are received by the taxpayer, IRC 453A(d)(1).

**Limit On Taxable Payment:** The amount of the taxable payment cannot exceed the excess of the total contract price over any portion of the contract price received before the time the secured debt is considered a payment, IRC 453A(d)(2).

**No Double Taxation:** To prevent double taxation, any subsequent installment payments are not taxed to the extent of the gain previously taxed because of the pledge, IRC 453A(d)(3).

**Exceptions: This Provision (Causing Taxable Gain) Does Not Pertain To The Following:**

(1) Where the selling price of the property securing the installment obligation is $150,000 or *less*, IRC 453A(b)(1).

(2) The property sold is personal-use property, such as a primary or second residence, IRC 453A(b)(3)(A).

(3) The property sold is business-use property used for farming, IRC 453A(b)(3)(B).
STRATEGIES FOR NUMBERS 5, 6, 7, AND 8:

Strategy 1: Come under one of the above four exceptions. If you are looking to come under exception 1 - the selling price of the property securing the installment obligation is $150,000 or less - then remember that for purposes of the $150,000 cut-off point, all sales or exchanges which are part of the same transaction shall be treated as one sale or exchange. Accordingly, any such multiple transactions should be separately documented with separate sales agreements, separate settlement sheets, etc.

Strategy 2: Follow the same planning recommendations as before: (1) Try to postpone any dispositions until the beginning of the next tax year; (2) Look for tax losses or deductions to reduce taxable gain; (3) Consider not electing installment sale reporting. See Chapter 39-A on making this decision.

The following types of dispositions will not cause the gain to be taxed:

9. A TRANSFER OF THE INSTALLMENT NOTE BETWEEN SPOUSES OR INCIDENT TO A DIVORCE AS PER IRC 1041: Here no gain (or loss) is triggered, IRC 453B(g). The same tax treatment that pertained to the transferor shall apply to the transferee. Thus, where installment sale has been elected by the transferor, the installment sale remains in place to the transferee and taxes are due as the installment payments are received. Also, the interest portion of the installments remains taxable as ordinary income.

10. A TRANSFER OF THE INSTALLMENT NOTE UPON DEATH: The transfer of the notes upon the death of the property owner will not accelerate the gain to the estate or heirs, IRC 453B(c). However, as the installment sale
remains in place, taxes are still due as the installment payments are received. Also, the interest portion of the installments remains taxable as ordinary income.

**ALERT ON ONE EXCEPTION**: The remaining unreported installment gain will be fully taxable to the deceased seller’s estate if the installment obligation is transferred to the **borrower (or obligor)** by reason of gift or inheritance, or is canceled by the estate. IRC 691(a)(4) and(5)(A); *Estate of Robert Frane*; PLR 9108027.

This scenario often happens among family members.

**EXAMPLE 9**: JJ sells on the installment basis a property to his son, LL. Subsequently, JJ dies and his will calls for the transfer of the installment note to LL. That is, LL inherits the note. **Tax Result**: The remaining unreported gain is fully taxable to the estate of JJ. The same result would happen if the note was not transferred to LL, but instead the estate cancels LL’s obligation on the note, IRC 691(a)(5)(A)(ii); or LL’s obligation becomes unenforceable, IRC 691(a)(5)(C). Again, the same result would also happen if the note was gifted to LL during JJ’s lifetime, IRC 453B(a); IRC 691(a)(4) and 5(A). (See Disposition 4 in this chapter.)

**STRATEGIES**: Follow the same planning recommendations as before:
(1) Try to postpone any dispositions until the beginning of the next tax year;

(2) Look for tax losses or deductions to reduce taxable gain; (3) Consider not electing installment sale reporting. See Section 39-A on making this decision.

**TAX REMINDER**: The above taxable events will only happen when the deferral of gain of installment sale reporting is elected. If the taxpayer elects out of installment sale and fully reports the entire gain in the year of sale, then there will be no gain on the sale, transfer or disposition of the note if the note is sold for an amount that is equal to or less than its face value.
value. In fact, there will be a loss, if the note is sold at a discount for less than its face value.

THE FOLLOWING ARE NOT CONSIDERED TO BE TAXABLE DISPOSITIONS OF INSTALLMENT OBLIGATIONS:

1. A change in the terms of the obligation, such as splitting a single note into two notes with similar terms, RR 74-157.

2. A substitution of borrowers, deeds of trusts or promissory notes where the terms and conditions of such substituted documents are not changed, RR 75-457; RR 82-122.

3. An increase in the interest rate and deferral of principal payment dates, due to financial difficulties of the buyer\borrower, RR 68-419. See also RR 82-122.

ALTERNATE STRATEGY: Eliminate installment sale reporting (and the above potential taxable dispositions) with three tax planning techniques:

1. Use the Self-Directed IRA (SDIRA) as a cash loan to the buyer, instead of electing installment sale.

2. Use the 1031 tax-free exchange, instead of electing installment sale.

3. Combine the SDIRA with the 1031 tax-free exchange, instead of installment sale.
By eliminating (or reducing) installment sale reporting, you eliminate (or reduce) the above taxable dispositions and related traps.

For a further discussion, see Chapter 39-B.

Reference Source (return tab): SAP 26A
Creative Seller Financing Scenario -- Use A One Payment Installment Sale To Defer $30,000 In Taxes And Still Cash Out

Installment sale reporting does not have to be a drawn-out 5, 10, or 30 year term. Remember the tax definition of installment sale as per IRC 453(b)(1) is quite simple - a sale or disposition of property where at least one payment is to be received after the close of the taxable year in which the sale or disposition occurs. (Emphasis added on one payment).

This provision can create an effective tax planning strategy toward the end of the year, especially for larger transactions with substantial down payments.

EXAMPLE 1 (Without Installment Sale): On December 1, of the current year MS sells a property for $500,000, with selling expenses of $30,000, an adjusted basis of $220,000 and a resultant realized gain of $250,000. Assume a total federal and state tax bracket of 30% and that there is no depreciation recapture. This is an all cash sale as the buyer is putting $200,000 down and is obtaining their own $300,000 mortgage from an outside lender. The tax liability on the cash sale is $75,000 ($250,000 gain x 30%).

EXAMPLE 2 (With Installment Sale): Same facts as above, except that MS elects a one payment installment sale by taking back the $200,000 down payment as a second mortgage, to be received by January 2, of the following year (only a
one month wait). The first year’s payment will be $300,000 cash from the buyer’s own mortgage. MS now qualifies for installment sale in the current year as follows:

**Gross profit ratio:**

Gross profit (or realized gain) $ 250,000  
Divided by contract price $ 500,000  
= Gross profit ratio 50%

**Taxable Gain:** The taxable gain under the installment sale for the first year is:

$300,000 (Cash Payment) x 50% (GP ratio) = $150,000, the taxable gain.

**Tax Impact (first year):** By doing this, the taxable gain of $150,000 x 30% tax bracket = $45,000 taxes, which is $30,000 less than the total taxes of $75,000 without installment sale. In other words, by only waiting one month for the remaining $300,000, Mrs. Seller has deferred $30,000 in taxes for the current tax year.

**Cash Impact:** “Deferral” = Sooner is better than later! It is true that the taxes are only deferred and not eliminated. However, when MS receives the remaining $200,000 in January of the following year, she does not have to pay the deferred taxes on the $200,000 until the following April, or a year and three months later (barring any requirements for quarterly estimated taxes). In the meantime, she has effectively employed the time value of money by having the tax dollars now, to invest for additional earnings.

**If the $30,000 deferred tax savings generated a 10% yield in a year and three months, the earnings would be almost $4,000 and at 15% the earnings would be almost $6,200.** Suppose MS used the $30,000 to buy a bargain property and quickly flip it for a clear profit of $10,000. There are many more income opportunities when the cash is in your hand as opposed to the IRS’s!
Moreover, we assumed a 30% tax bracket in the year of sale. In the later year when MS has to report the remaining deferred gain, she may be in a lower bracket (especially with our Goldmine tax planning strategies). In this case, the tax savings would even be greater because of this one payment installment sale.

Safety Impact: Also, the risk of default is very low, because there is only a one month waiting period and the buyer is committing $300,000 cash into the property.

TIP: Even though it is only for one month, the $300,000 note should be properly secured as a recorded mortgage or deed of trust on the property. Seek legal counsel.

TAX REMINDER: In the above scenario, instead of installment sale, a 1031 tax-free exchange would have been much more effective in saving taxes. Of course, for whatever reasons, individuals do not always want to do a 1031 exchange. But they should do the best they can under their particular circumstances. The above strategy is much better than doing nothing!

Reference Source (return tab): SAP 26, Part E

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious
copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Seller Financing -- How To Decide To Elect Installment Sale To Defer Gain, Or Elect Out Of Installment Sale To Include The Gain

Reference Source (return tab): SAP 26, Part F

The manner of how to elect (or elect out) of installment sale was discussed in Chapter 35. In this chapter we discuss the 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). Because the election is generally irrevocable, the decision of whether you should elect, or elect out of installment sale needs to be made before the due date of the tax return, plus extensions. (However, before deciding to elect out of installment sale, there are other factors you should consider. These will be discussed shortly.) For now, the following are some guidelines:

(1) Electing Installment Sale: Obviously, you should elect installment sale when you are a non-dealer and in a high bracket in the year of sale. Here, you want to defer the capital gains’ taxes. This election for installment sale will become even more effective if your bracket will decrease in the future, either because you will be making less taxable income, or because of tax legislation.

(2) Electing Out of Installment Sale: On the other hand, you could elect out of installment sale and accelerate the full installment gain in the following scenarios:
(a) When you want to use the full installment gain to offset losses or deductions that you do not want to waste for the current year. An important part of tax reduction planning is not wasting deductions. This is especially so when you are in what I call a “limbo layer of deductions”. This is where your present business losses are enough to offset most of your other income, but not all of it. However, whatever other income is not offset by business losses is offset by your personal itemized deductions and personal exemptions. In this situation you will not have any loss carryovers, such as a net operating loss (NOL). Here you really do not need any more deductions. Any more may be wasted, unless you accelerate the installment gain. Now you have income that can absorb these deductions. Here, the election-out will become even more effective if your bracket will increase in the future, either because you will be generating more income, or because of tax legislation.

(b) Similar to (a) above, you want to use the full installment gain to offset an expiring net operating loss (NOL). There is a time limit on how long you can carryover an NOL. It is 20 years. (For more about NOL’s, see Chapter 28.) The same would hold true for expiring unused charitable contributions. Here too there is a limit as to the amount of time of the carryover. These have up to 5 years. (Again, this election-out will become even more effective if your bracket will increase in the future, either because you will be generating more income, or because of tax legislation.)

**ALERT – BUT YOU MAY WANT TO ELECT INSTALLMENT SALE:**

You should think twice about electing out and accelerating the installment gain to offset losses or deductions that will not be wasted in the current year, but that can be carried forward.

Examples of these types of losses are suspended passive losses (these can be carried forward indefinitely), capital losses in excess of $3,000 (these too can be
carried forward indefinitely) recent NOL’s not about to expire (up to 20 years as a loss carry forward), and recent unused charitable contributions not about to expire (up to 5 years as a deduction carry forward). There are several reasons for considering to elect installment sale with these types of carryover losses:

(1) At least part of these unused losses can be used to zero out the taxable installment gain in the first year installment sale is elected. The remaining unused loss carry-forwards can then be used to offset the taxable installment gain in future years.

(2) The remaining unused loss carry-forwards can be used as offsets to income in future years where you may be in a higher tax bracket.

(3) The first $3,000 of capital loss carryforwards can be used against ordinary income (such as interest income), which is taxed at higher rates.

(4) **This is an important one.** If you elect out of installment sale and the IRS subsequently disallows all or part of the loss/deductions used to offset the fully reported gain, you are then stuck with paying tax on all or part of the installment gain (which, at this time, would be non-cash, phantom income). Had you elected installment sale, then at least you would be deferring taxes on the gain. Again, these elections are generally irrevocable.

Below are some examples of electing out of installment sale and examples of electing installment sale.

**EXAMPLE 1 - ELECTING OUT OF INSTALLMENT SALE WITH LOSS OFFSETS:** Refer to Example 1 in Chapter 35, where the total realized gain on the sale was $60,000. (Assume all of this is a capital gain.) The taxable gain from electing installment sale was $18,287 in the first year of sale. Assume that there was also a loser stock that was sold for a capital loss of $60,000. Because a loss on the sale of stock is considered a “capital” loss, it is limited to only
$3,000 a year as a deduction against ordinary income. The remaining unused loss can be carried forward (not back) indefinitely. However, if you elect out of installment sale by reporting the entire gain of $60,000, this capital gain of $60,000 can be fully offset by the $60,000 capital loss on the stock.

At first glance, the above example makes it appear that electing out of installment sale was a prudent decision. But look at the next example.

EXAMPLE 2 - ELECTING OUT OF INSTALLMENT SALE WITH LOSS OFFSETS:

Same facts as the above example, except that the IRS subsequently determines that you used an incorrect basis for the above stock loss. Consequently, instead of the above capital loss being $60,000, it’s only $20,000. Now you are stuck with paying tax on $40,000 of the installment gain (much of which will be non-cash, phantom income). Had you elected installment sale, then at least you would be deferring taxes on this gain.

NOTE: These same types of subsequent IRS changes have happened with NOL carryovers, passive loss carryovers and charitable deduction carryovers.

Again, think twice as we look at the next three examples.

EXAMPLE 3 - ELECTING INSTALLMENT SALE WITH LOSS OFFSETS:
Same facts as Example 3, except you do elect installment sale reporting. There is no IRS disallowance and you have the $60,000 capital loss on the stock sale. Result: Of the $60,000 capital loss, you still will use $18,287 to fully offset the taxable installment gain of $18,287 (which is a capital gain). You therefore pay zero taxes on the installment sale. Moreover, you can use another $3,000 to offset other ordinary income, such as the interest on the installment note. (You can use even more of the capital loss if you have additional capital gains). Consequently, you have used up $21,287 ($18,287 + $3,000) of the total $60,000 capital loss. This leaves $38,773 of unused capital losses that can be
carried forward, indefinitely, to offset future income, including installment sale gains, and up to $3,000 against other ordinary income, taxed as high as 40% (such as interest on the note). Again, you can use even more of the capital loss if you have additional capital gains.

**EXAMPLE 4:** Assume the next year, your taxable installment gain is only $350. However, your interest income is $6,235 and you have a capital gain of $5,000 from a stock sale. Your unused capital loss carryforward of $38,773 can be used as follows:

To offset the entire installment sale gain ........................................... $ 350  
To offset the entire capital gain on the stock ................................. +  5,000  
To offset almost half of the $6,235 ordinary interest income by...+ 3,000  
= Total capital losses used .................................................................= 8,350  
Less: Prior unused amount ..............................................................- 38,773  
= Unused capital loss carry forward for next year ..........................= $30,423  

The above capital loss carry forward of $30,423 again can offset future income, including an early payoff on the installment note.

**EXAMPLE 5:** Assume that in January 1 of the next year, the buyer\borrower pays off the remaining balance on the note of $69,000. With a 60% gross profit ratio, the payment of the $69,000 would result in taxable gain of $41,400 from which you can offset $30,423 of the remaining unused losses, leaving taxable income of only $10,977. Moreover, if the IRS subsequently disallows any of the above loss offsets, you still have your deferred gain because you elected installment sale.

Reference Source (return tab): **SAP 26, Part F**
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Replace Installment Sale Reporting Altogether - Cash Out With A Self-Directed IRA Yet Still Offer Seller Financing -- Combine With A 1031 Tax-Free Exchange

Reference Source (return tab): SAP 26, Part G

By eliminating installment sale reporting, you eliminate the many related traps. In this chapter we will discuss the following:

A. USE THE SDIRA, INSTEAD OF INSTALLMENT SALE

B. USE THE 1031 TAX-FREE EXCHANGE, INSTEAD OF INSTALLMENT SALE

C. COMBINE THE SDIRA WITH THE 1031 TAX-FREE EXCHANGE, INSTEAD OF INSTALLMENT SALE. COMBINE 3 POWER PLAYS INTO ONE BIG SUPER PLAY

A. USE THE SDIRA, INSTEAD OF INSTALLMENT SALE

Here is how this works:

(a) The seller agrees to sell a property to a buyer for a certain cash down payment and the availability of seller financing for the balance of the price.
(b) Instead of the seller holding the financing in the form of “paper”, they (the seller) lend the unrelated* buyer the cash from their Self Directed IRA, qualified, Simple or Sep plan (SDIRA). That is, the SDIRA lends the buyer the cash to buy the property. The buyer then comes to the settlement table with all cash (instead of a note). The seller cashes out on the sale. A variation of this technique is to have another unrelated SDIRA (other than the seller’s) lend the buyer the cash. (*The buyer cannot be a direct lineal descendant or 50% or more owned entity.)

(c) The buyer, as the mortgagor, will still have a mortgage obligation, but with the SDIRA as the mortgagee, instead of the seller. The buyer will make the mortgage payments to the SDIRA. Because it is a retirement plan, the SDIRA pays no tax on any of the payments, including the interest. All payments received (including balloon payments) are tax deferred.

(d) The seller cannot elect installment sale. Reason: They received all cash from the sale.

**ALERT:** For the above, see the tax alert at the end of this section.

For the seller, this is a total taxable disposition, but there are the following advantages:

(1) The interest on the buyer note is tax deferred within the seller’s SDIRA.

(2) The SDIRA can sell, gift, cancel, exchange, pledge, or otherwise dispose of the note without incurring taxable gain, because it is in a retirement plan. Any early payoffs of the note, such as a balloon, will also escape taxation.

(3) The seller still can reduce, eliminate or defer gain on the cash sale by using the many planning strategies discussed in Chapter 31. One of these strategies is a 1031 exchange (see next strategy).
B. USE THE 1031 TAX-FREE EXCHANGE, INSTEAD OF INSTALLMENT SALE

The part of the sales price that is toward the seller takeback 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, principal payments and possibly other types of “phantom” payments as per Chapter 36.

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

(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 replacement property can be sheltered through componentizing and other property expense deductions, and even create “paper” losses which in turn generate tax savings.

(4) With a 1031 there can be a total deferral of tax liabilities (including depreciation recapture) 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. (see Section VI of *The 1031 Money Machine*).

**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 from the buyer or a co-signer 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 SDIRA. Perhaps you could co-sign to assist in the financing or lend the buyer the cash (see the strategy on the next page).

**Get Tax-Free Cash at 0% Interest** -. For more info go to [www.goldminevipaccess.com](http://www.goldminevipaccess.com), triple click to the green color banner for this great program.

**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 the exchange escrow account and qualify for a 1031 exchange.
C. COMBINE THE SDIRA WITH THE 1031 TAX-FREE EXCHANGE, INSTEAD OF INSTALLMENT SALE.
COMBINE 3 POWER PLAYS INTO ONE BIG SUPER PLAY

1. SELLER FINANCING = A quicker sale for top market dollar

2. Self-Directed IRA (SDIRA) = Instant availability of cash and tax-free compounding.

3. 1031 TAX-FREE EXCHANGE = Tax-Free profits on the sale. Rollover the tax-free profits into a superior real estate investment.

That is, combine the SDIRA with the 1031 exchange, instead of installment sale. Here, you still offer selling financing but cash out by having your SDIRA lend the buyer the cash to buy the property. 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 the exchange escrow account and qualifies for the 1031 exchange. (REMINDER: An installment note does not qualify for a 1031 exchange, but cash does.)

EXAMPLE 8: JR owns an investment property free & clear that can sell anywhere from $190,000 to $200,000. JR’s RE agent tells JR that by holding the financing, the property will sell quicker and for the full price of $200,000. At a $200,000 price the outright sale of the property would result in a realized gain of $140,000 which would result in $35,000 in taxes on the sale (assuming a rounded 25% tax bracket). But JR does not want to pay these nasty taxes and does not want to hold any “paper”. Instead, she wants all *cash* to escrow in a 1031 tax-free exchange and use the cash to buy a superior property. With the 1031, JR will totally avoid paying $35,000 in taxes, which she can use as a
down payment for superior property. Assume that JR has over $200,000 in her IRA’s (from wholesale flips).

THE SOLUTION FOR JR:

1. SELLER FINANCING - JR will provide $180,000 seller financing to the unrelated buyer and therefore get the full price of $200,000. Assume that the buyer has $20,000 to put down.

2. SDIRA - JR will provide the financing, not by holding the “paper”, but by lending the (unrelated) buyer $180,000 cash from her SDIRA (10%, 30 yrs, 7 yr. balloon). A note and a mortgage on the $180,000 financing is executed with the buyer as the mortgagor and JR’s SDIRA as the mortgagee. (We’ll come back to the SDIRA shortly.)

3. 1031 TAX-FREE EXCHANGE - Instead of a non-qualifying note, the buyer then comes to the settlement table with all qualifying cash of $200,000 ($20,000 DP and mortgage of $180,000). With no property debt and selling expenses of $10,000, the net cash proceeds are $190,000 ($200,000 - $10,000). The $190,000 is escrowed as part of the 1031 exchange.

To complete the 1031 exchange, JR uses the $190,000 as a 25% DP (including CC) and acquires a replacement property for $760,000, or almost 4 times more than the property she sold via the 1031. The higher valued property is in a much better location, with a much higher appreciation-rate and is generating substantially more cash flow than JR’s former property.

>>BACK TO THE SDIRA - In the meantime JR’s SDIRA is collecting monthly payments of $1580 on the buyer’s note. Most of this payment is interest, but all tax-free. PLUS: The final balloon payment in 7 years will also not be taxed, PLUS: JR can sell all or part of her note for a tax-free profit within her SDIRA.
From the full or partial sale of the note, her SDIRA can use the proceeds to buy & flip a bargain property for a quick tax-free profit; lend money at high (tax-free) interest rates; invest in paper; flip an assignable agreement for quick tax-free profits and just repeat the tax-free money-making machine!

**RECAP OF JR’S SUPER TAX-SAVING PLAY:**

* Via seller financing, sold the property quicker at top market dollar.

* Yet, still cashed out via the SDIRA mortgage-loan to the buyer.

* Via 1031, paid NO taxes on the entire cash profit from the sale.

* Via 1031, has new property with more appreciation & cash flow.

* Via SDIRA, pays NO taxes on all income from the mortgage.

* The SDIRA can reinvest the mortgage tax-free income into more tax-free income.

**ALERT:** Some practitioners may take the position that your SDIRA loan to your buyer is a “prohibited” transaction where there could be costly penalties. I have consulted with experts and they have said that it is not. I agree with the experts, provided that the buyer is an unrelated party per IRS rules (IRS Pub. 590).

**TIP:** With your Renaissance VIP code, email us for experts on self-directed IRA’s at taxbible@aol.com.

Reference Source (return tab): **SAP 26, Part G**
Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
Renting/Selling Property Via Lease-Options

Reference Source (return tab): SAP 27

In this chapter we will cover...

A. BASIC OPTION DEFINITIONS

B. TAX EFFECTS OF LEASE-OPTIONS FOR SELLER-OPTIONOR

C. TAX REPORTING FOR SELLER-OPTIONOR WHEN OPERATING AND RENTING THE PROPERTY VIA LEASE-OPTIONS

A. BASIC OPTION DEFINITIONS

1. OPTION - An option contract is a unilateral agreement that binds the owner of the property to sell the related property for a fixed or determinable price within a specified time. It is unilateral because only the seller (“optionor” or “grantor”) must sell, but the prospective buyer (“optionee” or “grantee”) is not required to buy. The option gives the buyer a right (or option) to buy a property at a future date, but not the obligation.

2. LEASE-OPTION - A lease-option is where the option to purchase the property is combined with leasing the property. This chapter covers lease-options and is targeted for the entrepreneur who has already purchased a property (as opposed to have “optioned” the property), and wants to rent/sell it creatively via a lease\option. With a lease-option, the seller (our entrepreneur) is also called the
“optionor” or “grantor”; where as the tenant/buyer is also called the “optionee” or “grantee”.

**ALERT:** You have to be careful of lease-options as disguised installment sales as per Chapter 40-C.

3. **THE PROPERTY OWNER** - Is called “owner”, “seller”, “optionor”, “lessor”, “landlord”. And combinations such as “seller-optionor”, “seller-optionor-lesser”, (which is probably the most technically correct) or “landlord-seller” which to keep it simple is what I will use the most for lease-options - “landlord-seller”. But they may be used interchangeably.

4. **THE BUYER** - On the other hand, the buyer is called “buyer”, “optionee”, “lessee”, “tenant” or “resident”. And combinations such as “buyer-optionee”, “buyer-optionee-lessee” (which is probably the most technically correct) or “tenant-buyer”, which to keep it simple is what I will use the most for lease-options - “tenant-buyer”. But they may be used interchangeably.

### B. TAX EFFECTS OF LEASE-OPTIONS FOR SELLER/OPTONOR (LANDLORD-SELLER)

| 1. WHEN THE OPTION PAYMENT IS RECEIVED BY THE LANDLORD-SELLER |
| 2. WHEN THE OPTION IS EXERCISED BY THE TENANT-BUYER |
| 2A. IRS REPORTING FOR SALE OF OPTIONED PROPERTY BY THE LANDLORD-SELLER |
| 2B. PLANNING STRATEGIES FOR LANDLORD-SELLER FOR OPTION EXERCISE |
3A. IRS REPORTING BY LANDLORD-SELLER FOR UNEXERCIZED OPTIONS

3. IF THE OPTION IS NOT EXERCISED; IT LAPSES AND THE LANDLORD-SELLER KEEPS THE OPTION DEPOSIT

4. REVERSE TAX PLANNING FOR LANDLORD-SELLER FOR THE RECEIPT OF OPTION PAYMENTS

1. WHEN THE OPTION PAYMENT IS RECEIVED BY THE LANDLORD-SELLER: Option payments received are tax deferred because it is an open transaction until the option is exercised, sold or expired. See Reg. 1.1234-1(b) and Dill Co., 33 TC 196, aff’d, 294 F.2d 291. An option is a different asset from the underlying property and is treated much like an earnest money deposit (which is also tax deferred), Lucas v. North Texas Lumber Co., 281 US 11 (1930).

NOTE: Regulation 1.1234-1(b) does not directly say the receipt of an option is tax deferred. Instead, it does so indirectly by making the presumption that that any taxability of the option only occurs when it later lapses, or is later exercised, and not at the time of its receipt.

TAX BREAK: 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. Here, the owner (landlord-seller) can immediately use the tax-deferred cash to reap high yields from other investments.

EXAMPLE 1: RR receives a $20,000 option deposit on one of her properties. While she must take the property off the market and hold it just for the buyer\optionee, RR does not have to escrow the $20,000. She uses the $20,000 to buy a bargain property, which she quickly flips for a $10,000 clear profit. RR has made a nice 50% return on the use of the tax-deferred option money. (She has used “taxes” to make more money!) Of course, she can continue to use and snowball the accumulated funds into more profitable investments.
**STRATEGY:** Tax deferred option payments can be spread out over years.

**EXAMPLE 2:** BB will receive a $50,000 annual option deposit on a property over a period of 4 years. That’s $200,000 of tax-deferred cash BB can use for other investments (assuming that other interested parties do not require the funds to be escrowed).

2. **WHEN THE OPTION IS EXERCISED BY THE TENANT-BUYER:** The option amount is included in the selling price of the property, where there will be a recognized gain or loss. IRC 1001(b); Reg. 1.1001-2(a). The character of the gain on the property (capital or ordinary) will depend on the character of the underlying property and if there is any depreciation recapture. (See Chapters 29 & 30). The character of a loss on the property (capital or ordinary) will also depend on the character of the underlying property. (See Ch. 44). See below for IRS reporting.

| 2A. IRS REPORTING FOR SALE OF OPTIONED PROPERTY BY THE LANDLORD-SELLER: |
| IRS Reporting Of The Sale Of Optioned Rental-Type Property: (Such As Houses Or Apartments, Other Than Land). If the property is held less than one year and one day, report the sale as ordinary income on IRS Form 4797, page 1, part II, “Ordinary Gains and Losses”. If the property is held more than one year and one day, report the sale as a long-term capital gain (taxed at lower rates) on IRS Form 4797, page 2, part III, “Gain From Disposition of Property Under Sections 1245, 1250.” Also, use IRS Schedule D, “Capital Gains and Losses”, part II. |

2B. **PLANNING STRATEGIES FOR THE LANDLORD-SELLER FOR THE OPTION EXERCISE:**
1. **LONG-TERM CAPITAL GAIN** - If you are selling and you are near the one-year, one-day holding period, schedule closing so you meet this one-year and one-day holding period and pay lower capital gain taxes.

2. **1031 EXCHANGE** - If the option is exercised, then sell the property to your buyer, tax-free, via a 1031 move-up exchange. This is powerful!

**EXAMPLE 3 – 1031 MOVE-UP EXCHANGE:** You lease\option a property (that you have previously owned) for a 2-year option term; you receive an upfront deposit of $5,000 and an option price of $150,000. Because your tax basis is $80,000, the taxable gain would be $70,000 and your capital gain’s taxes $20,000. The tenant/buyer decides to exercise their option and purchase the property from you. Before the closing you hire a Qualified Intermediary (“QI”) which executes the proper 1031 exchange documents and escrows the net proceeds from the closing. As a 20% down payment, the above tax savings of $20,000 allows you to purchase an additional $100,000 of 1031 replacement property over the one you sold for $150,000. This means you acquire a $250,000 property, which is in a much better location, generating more cash flow with more potential for appreciation. (The combination of creative strategies such as lease\options and 1031 exchanges is a virtual tax-free money-making machine!)

**Option Deposit is Taxable Boot. Planning to Avoid** - The $5,000 option deposit in this 1031 example is taxable boot, but would not disqualify the rest of the 1031 exchange (if properly structured). The seller\exchangor in the above example may arguably avoid taxable boot on the $5,000 deposit (and any monthly option payments) by later depositing them in the exchange escrow account prior to the settlement of the relinquished property (IRS Letter Ruling 7952086). In the exchange documents there should be language that states that all deposits received by the investor are to be assigned* to the Qualified Intermediary (“QI”).

(*The deposit assignment to the QI is not a physical cash transfer, but instead a “paper” assignment typically and properly used in 1031 exchange documents).
Advanced 1031 Planning: If at the time of the option, you know you are going to do a 1031 exchange upon the option’s exercise, then you should engage the QI before receiving or paying option deposits. The positive result is that right from the beginning, all deposits will go through the QI and all exchange documentation could be set up in advance. Any trace of constructive receipt can be totally eliminated. (Note: You should engage the QI in advance. Email us for an expert with your Renaissance VIP code at taxbible@aol.com).

3. IF THE OPTION IS NOT EXERCISED BY THE TENANT-BUYER; IT LAPSES AND THE LANDLORD- SELLER (SELLER-OPTIONOR) KEEPS THE OPTION DEPOSIT: Here the gain is ordinary income, regardless of the character of the underlying property and regardless of the holding period of the property, Reg 1.1234-1(b). For IRS reporting, see below.

**ALERT:** The landlord-seller\optionor should make sure they have the funds to pay any tax liabilities.

| 3A. IRS REPORTING BY LANDLORD-SELLER FOR UNEXCERIZD OPTIONS: | Report the gain from the option-lapse as ordinary income on IRS Form 4797, page 1, part II, “Ordinary Gains and Losses”. |

**STRATEGY:** Use a SDIRA. If the property was originally acquired in a self-directed IRA (SDIRA), then neither the lapse nor the exercise of the option will cause taxability. The option profit is further tax deferred with no reporting on any IRS 1040 ancillary forms, such as forms 4797 and/or Schedule D.

4. REVERSE TAX PLANNING FOR LANDLORD-SELLER FOR THE RECEIPT OF OPTION PAYMENTS: Report the option payments as income if you have enough offsetting deductions which would otherwise be wasted. It
is not mandatory that you have to defer the option payments. The reported income would then be offset by the deductions and would not have to be reported in a future year when the option is exercised or lapses. Report the option payments as an ordinary gain on IRS Form 4797, Page 1, Part II. Plan your tax situation accordingly.

C. TAX REPORTING FOR LANDLORD-SELLER WHEN OPERATING AND RENTING THE PROPERTY VIA LEASE-OPTIONS

1. DEPRECIATION DEDUCTIONS ON THE OPTIONED PROPERTY, ITSELF

2. INTEREST\PROPERTY TAX DEDUCTIONS

3. OTHER EXPENSE-DEDUCTIONS

4. CAPITAL IMPROVEMENTS MADE BY THE TENANT-BUYER ARE NOT INCOME TO THE LANDLORD-SELLER, UNLESS THEY ARE A SUBSTITUTE FOR RENT

5. ANY RENT INCOME RECEIVED BY THE LANDLORD-SELLER IS ORDINARY INCOME

6. IRS REPORTING BY LANDLORD-SELLER OF INCOME & EXPENSES

1. DEPRECIATION DEDUCTIONS ON THE OPTIONED PROPERTY, ITSELF: Because they are still the legal owner of the property, the landlord-seller would be entitled to the depreciation deductions on the property, itself. (This is so provided that the arrangement is a true lease/option as opposed to a disguised installment sale as discussed in Chapter 40-C) Note: The buyer/optionee is entitled to depreciation deductions on capital items that they paid for, assuming a
rental or business-use property; if a personal-use property there are no depreciation deductions for the tenant-buyer.

2. **INTEREST\PROPERTY TAX DEDUCTIONS**: Because they are still the legal owner of the property, the landlord-seller is also entitled to deduct the mortgage interest and property taxes.

   **NOTE**: The interest and property taxes are still deductible by the landlord-seller even if the mortgage payments on the optioned property are paid directly to the lender by the tenant-buyer. However, the tenant-buyer’s making of the mortgage payment is, in effect, rent income to the landlord-seller (as per number 5 below), and rent expense deduction to the tenant-buyer (assuming a rental or business-use property; if a personal-use property there are no rent expense deductions for the tenant-buyer).

   **ALERT**: This is all provided that the above arrangement is a true lease-option as opposed to a disguised installment sale as discussed in Chapter 40-C)

3. **OTHER EXPENSE-DEDUCTIONS**: Any other operating expenses paid by the seller/optionor (such as repairs or maintenance) are also deductible. Other deductible operating expenses include the following: Advertising, auto, travel, cleaning, supplies, insurance, legal fees, other professional fees, management fees, utilities, telephone, office supplies, postage, salaries, publications on real estate, equipment rental, eviction costs, dues for investor associations, tuition for real estate seminars. For a list of other deductions see Chapter 23.

4. **CAPITAL IMPROVEMENTS MADE BY THE TENANT-BUYER ARE NOT INCOME TO THE LANDLORD-SELLER, UNLESS THEY ARE A SUBSTITUTE FOR RENT**: Any improvements paid by the tenant-buyer are not income to the owner (landlord-seller), unless they are a substitute for rent. If they are a substitute for rent, then the owner (landlord-seller) the reports the cost of the improvements as ordinary rent income. On the other hand, the buyer/optionee could fully deduct the cost of the improvements as rent expense, assuming a rental
or business-use property; if a personal-use property there are no depreciation deductions for the tenant-buyer.

**Rent Income vs. Not Rent Income.** Whether such improvements are rent would depend on the terms of lease or other “surrounding circumstances”, Regulation. 1.61-8(c). (See also *McGrath*, 5th Circuit). The fact that the improvements increase the value of the property does not, by itself, constitute rent income to the owner (landlord-seller), *Blatt*, 305 US 267. Provided that it is clear that the parties do not intend the improvements to be rent, then it is immaterial if the improvements are to become the property of the owner upon the lease termination (or default by the tenant-buyer), *Cunningham*, 28 TC 670, aff’d, 258 F2d, 231.

**STRATEGY:** If the parties do not intend the improvements to be rent, then this should be clearly stated in the lease.

**TAX TREATMENT:** If the tenant-buyer’s improvements are not rent, then the tenant-buyer claims depreciation* on them. However, if they are for rent, then the tenant-buyer fully deducts their cost as rent expense* and the landlord-seller reports the cost as rent income and then the landlord-seller nor would be entitled to depreciate these items, not the tenant-buyer.

*Note:* The tenant-buyer claims the above deductions assuming a rental or business-use property; if a personal-use property there are no such deductions for the tenant-buyer.

**STRATEGY:** The parties to the lease-option should structure the payment of such improvements so that the one party who needs the deductions the most, gets them. For example, if the lessor is a self-directed IRA, then (assuming a rental or business-use property), the lessee (tenant-buyer) could fully deduct the cost of the improvements as rent, yet the self-directed IRA would not be taxed on this because it is a retirement plan. This could also work with a lessor (landlord seller) in a low tax bracket, outside of the SDIRA.
5. ANY RENT INCOME RECEIVED BY THE LANORD-SELLER IS ORDINARY INCOME: However, such rent can be offset by the above deductions.

**REMININDER:** Mortgage payments paid by the tenant-buyer-optionee is income to the Landord-seller-optionor: Sometimes as part of a lease-option arrangement, in lieu of making monthly rent payments to the landlord-seller, the tenant-buyer instead makes the mortgage payments on the optioned property directly to the lender. Such mortgage payments paid directly (to the lender) by the tenant-buyer is the equivalent of rent income to the Landord-seller because the mortgage payments are the obligation of the landlord-seller. However the landlord-seller deducts the mortgage interest and property taxes (not the tenant-buyer).

**EXAMPLE:** The seller’s mortgage payment is $1000 of which $900 is interest and property taxes (remaining $100 is principal). The tenant-buyer pays the landlord-seller’s mortgage payment directly to the lender instead of paying rent directly to the landlord-seller. This making of the mortgage payment of $1000 by the tenant-buyer is deemed to be rent income of $1000 to the landlord-seller who deducts the $900 interest and taxes (along with depreciation and other property deductions). The tenant-buyer can deduct the $1000 rent, only if they are using the property as a rental property or business-use property. If they are using the property as a personal-use residence the tenant-buyer is not entitled to any deductions.

**LEGAL NOTE:** Such arrangements must be carefully legally documented and monitored to ensure that mortgage payments are being made timely and properly.

6. IRS REPORTING BY SELLER-LANDLORD OF INCOME & EXPENSES: The above income and deductions of the landlord-seller are reported on the same IRS form for reporting income and expenses of any rental property such as Schedule E (not recommended) or the highly
preferred partnership tax return – form 1065.

Reference Source (return tab): SAP 27

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. BASIC DEFINITIONS

1. OPTION - An option contract is a unilateral agreement that binds the owner of the property to sell the related property for a fixed or determinable price within a specified time. It is unilateral because only the seller (“optionor” or “grantor”) must sell, but the prospective buyer (“optionee” or “grantee”) is not required to buy. The option gives the buyer a right (or option) to buy a property at a future date.

2. STRAIGHT-OPTION - A straight-option is where the option to purchase the property is not combined with leasing the property. Here our real estate entrepreneur is a buyer-optionee. There are no rental arrangements (so there are not the terms “tenant” or “lessee”). As the buyer-optionee, you can flip the straight option (itself) for a quick profit; or exercise the option and purchase the property which can be held for rental cash flow or sold for a profit... all with the
B. TAX ASPECTS OF STRAIGHT-OPTIONS FOR THE BUYER-OPTIONEE

1. PAYMENT - WHEN THE OPTION IS PAID FOR BY THE BUYER-OPTIONEE

2. EXERCISE - IF AND WHEN THE OPTION IS EXERCISED BY THE BUYER-OPTIONEE

3. FORFEITURE - IF THE OPTION IS NOT EXERCISED; IT LAPSES AND THE BUYER-OPTIONEE FORFEITS THEIR DEPOSIT – TAX TREATMENT

3A. THE CHARACTER (TYPE) OF THE LOSS ON THE FORFETTED OPTION PAYMENT BY THE BUYER-OPTIONEE

4. OPTION SOLD, NOT EXERCISED OR FORFEITED - THE SALE (OR EXCHANGE) OF AN OPTION BY THE BUYER-OPTIONEE

5. ALERT ON SELLING THE PROPERTY VERSUS SELLING THE OPTION, ITSELF

6. STRATEGIES FOR BUYER-OPTIONEE FOR TOTALLY AVOIDING TAXES ON THE OPTION SALE ITSELF

1. PAYMENT - WHEN THE OPTION IS PAID FOR BY THE BUYER-OPTIONEE: Tax neutral. That is, there is no taxable event at this point. The option payment is not tax deductible. Regulation 1.1234-1(b).
2. EXERCISE - IF AND WHEN THE OPTION IS EXERCISED BY THE BUYER-OPTIONEE: At this point the buyer includes the option deposit as part of the purchase cost of the property. IRC 1012.

EXAMPLE 1: You make an option payment of $2,000 toward the future purchase of a property for a price of $200,000. If the $2,000 is credited toward the $200,000 purchase, then the initial cost basis is 200,000, because the $2,000 is already included in the $200,000. However, if it is not credited toward the $200,000 purchase, then the initial cost basis is $202,000 ($200,000 plus $2,000). Here, the $2,000 was not included in the $200,000 option price.

TAX ALERT: The holding period of the option does not tack on to the holding period of the property. Reg. 1.1234-1(a)(1). Accordingly, if an optioned property is purchased after the option period, a subsequent quick sale of the property by the buyer-optionee (in a year or less), will result in higher-taxed ordinary income (or short-term capital gain) vs. lower-taxed long-term capital gain. For a further discussion, including planning strategies, see number 5 below.

3. FORFEITURE - IF THE OPTION IS NOT EXERCISED; IT LAPSES AND THE BUYER-OPTIONEE FORFEITS THEIR DEPOSIT: For an investment property, the buyer can deduct the option cost as a loss. (*For a further discussion of losses on dispositions refer to Chapter 44.)

3A. THE CHARACTER (TYPE) OF THE LOSS ON THE FORFEITED OPTION PAYMENT BY THE BUYER-OPTIONEE: This depends on the type of property as follows:

(1) Capital Loss - If the property is a capital asset (such as land held for investment), then the option-forfeiture loss is a capital loss, generally limited to $3,000, IRC 1211; Reg. 1.1211-1.
(2) Ordinary Loss - If a rental property, business-use property, or dealer property, then the option-forfeiture loss is a fully deductible ordinary loss, IRC 1231.

(3) Non-Deductible Loss - If personal-use property such as a first or second home, the option-forfeiture loss is not deductible*, Reg. 1.262-1(b)(4); Reg. 1.165-9(a).

* STRATEGY FOR PERSONAL LOSSES: To convert a non-deductible personal loss to a deductible investment loss, demonstrate that your intent was to hold the property for investment or business purposes, and not for personal-use. This intent should be documented in letters-of-intent, purchase agreements, minutes, correspondence, etc. For more about sale-loss strategies, see Chapter 44.

4. OPTION SOLD, NOT EXERCISED OR FORFEITED - THE SALE (OR EXCHANGE) OF AN OPTION BY THE BUYER-OPTIONEE: An option is a different asset from the underlying property. In the creative world of real estate investing, sometimes instead of exercising the option, the buyer-optionee sells (or “flips”) the option (itself) for a gain or loss to another buyer-optionee. The character of the gain or loss on the sale of an option will depend on the character of the underlying property (such as land, rental property or dealer property), IRC 1234(a)(1). It will also depend on the holding period of the option, Reg 1.1231-1(a). All of this follows:

(1) Investment Land (Capital Asset) - You have an option on land you intend to hold for investment. You have held the option for a year and one day (or longer). You sell the option. The gain on the sale of the option is long-term capital gain. A loss on the option sale would also be capital. Reason: The underlying property (land) is a capital asset and the option was held for the required long-term capital gain period of one year and one day (or longer).
IRS Reporting of Optioned Land Sales: If the land is held less than one year and one day, report the sale as a short-term* capital gain on IRS Schedule D, “Capital Gains and Losses”, part 1.

*Reporting Strategy: You still want to report the gain as a short-term capital gain, even though a short-term capital gain is taxed at the same higher rates as ordinary income. Reason: You can fully offset capital losses (such as a stock loss) against capital gains. A capital loss is limited to only $3,000 a year as a deduction against ordinary income (unused losses are carried forward). But capital gains can be fully offset by capital losses. If the land is held more than one year and one day, report the sale as a long-term capital gain (taxed at lower rates) on IRS Schedule D, “Capital Gains and Losses”, part I1. Again, You can fully offset capital losses (such as a stock loss) against capital gains, short or long-term.

(2) Rental/Business Property (1231 Asset) - You have an option on a property that you intend to hold for rental. You have held the option for a year and one day (or longer). You sell the option. The gain on the sale of the option is long-term capital gain. However, the option-forfeiture loss on this option sale would be a preferential fully deductible ordinary loss (not a capital loss). Reason: The underlying property is a 1231 asset* and the option was held for the required long-term capital gain period of one year and one day (or longer).

[*Section 1231 rental or business-use property receives preferential treatment in that the gain is capital (except for recapture), yet the loss is ordinary. For a further discussion of Section 1231 assets, see Ch. 29 for gains; Chapter 44 for loses].

STRATEGY FOR GAINS – LONG-TERM CAPITAL GAIN:
If you are selling and you are near the one-year, one-day holding period, schedule closing so you meet this one-year and one-day holding period and pay lower capital gain taxes. The holding period begins on the day after the
acquisition date and ends on the date of disposition. Thus, the closing day of the purchase is excluded, while the closing day of the sale is included. Rev. Rul. 70-598.

**IRS Reporting For Gains:** Report the sale as a long-term capital gain (taxed at lower rates) on IRS Form 4797, page 2, part III, “Gain From Disposition of Property Under Sections 1245, 1250.” Also, use IRS Schedule D, “Capital Gains and Losses”, part II.

**IRS Reporting For Losses:** Report the sale as an ordinary loss on IRS Form 4797 “Sales of Business Property”, page 1, parts I and II. Here you do not use Schedule D.

(3) **Ordinary Income Property (So-Called “Dealer” Property)** - You have an option on a property that you intend to “develop and sell”. Your unknowledgeable tax preparer says this is “dealer property”. You have held the option for a year and one day (or longer). You sell the option. The gain on the sale of the option is ordinary (not capital), even though it was held for the long-term capital gain period. A loss on the option sale would also be ordinary (regardless of holding period), Reg. 1.1234-1(d). *Reason:* According to your tax preparer, the underlying property is “dealer” (ordinary income*) property.

**AVOIDANCE STRATEGIES FOR ABOVE:**

(1) Convert the above ordinary income into long-term capital gain by documenting that you are not a dealer in real estate with investment intent and rid of “develop and sell” and the tax preparer. See ch. 42 for a discussion of how to avoid dealer status.

(2) On the other hand, if the loss were going to be a capital loss (such as from an option on a land investment), then it may be advantageous to be
considered a dealer, in this transaction. \textit{Reason}: The loss would be a fully deductible ordinary loss.

(2A) If you do this, clearly separate this one dealer transaction from the investor transactions. But first determine if it is worth it.

(3) Plan accordingly and carefully!

5. ALERT ON SELLING THE \textit{PROPERTY} VERSUS SELLING THE \textit{OPTION, ITSELF}: The holding period of the option does \textit{not} tack on to the holding period of the property. Reg. 1.1234-1(a)(1). Accordingly, if an optioned property is purchased after the option period, a subsequent quick sale of the property (in a year or less), will result in higher-taxed higher-taxed ordinary income (or short-term capital gain) vs. lower-taxed long-term capital gain.

\textbf{EXAMPLE - QUICK SALE AFTER PURCHASE OF OPTIONED PROPERTY}: You have a two-year option (of $2,000) on an investment property for a purchase price of $200,000. Just before the end of the two-year option period you receive an offer to sell the property for $280,000 (net of selling expenses). This equates to an $80,000 profit ($280,000-200,000). You exercise your option, close on buying the property for $200,000 and the next day close on selling the property for $280,000. Because your holding period is only \textbf{one day}, you have ordinary income of $80,000, or $32,000 in taxes, assuming a rounded 40% bracket.

\textbf{STRATEGIES FOR THE ABOVE}:

(1) Sell the \textit{option itself} for the $80,000 profit, which would be a long-term capital gain, because you have held the \textit{option} for the long-term capital gain period. Instead of $32,000, the taxes would be $16,000 (20\% of the $80,000 gain). (A difference of $16,000!)
**TIP:** Doing it this way could also save on transaction costs, including transfer fees (which can be significant in some locales).

(2) **If you do not sell the option and acquire the property, then hold the property for the long-term capital gain period (which is presently one-year and a day) in order to take advantage of the long-term capital gain.**

If the buyer needs the property, they could lease it from you for at least one year and one day. Make sure that the lease is a pure *rental* arrangement that does not give the buyer-optionee any equitable ownership (where they would have the “burdens & benefits” of ownership). In this same scenario you may be able to sell the property, tax-free, via a move-up 1031 exchange. For other strategies to reduce, defer or eliminate taxes on the sale of property, see Chapter 31.

**6. STRATEGIES TO TOTALLY AVOIDING TAXES ON THE OPTION SALE ITSELF:**

(1) **Do a 1031 tax-free exchange on the option, itself?** It is unclear if an option (or any contract) can qualify as like-kind property in a 1031 exchange. To qualify, the option contract would have to be considered an interest in real property. At least some 1031 experts believe than treating a contract or option as like-kind to a fee interest in real estate is highly questionable. However, the courts have considered contract rights to purchase real property as real property rights. See *Starker v. US*, 602 F2d 1341 (CA9, 1979).

**NOTE:** Sometimes a contract to purchase real estate extends for a lengthy period of time. Thus, if the contract or option was held for one to two years, then it may have a better chance to qualify for a 1031 tax-free exchange under the exchange “holding” requirement discussed in Ch. 34. But this is still on the higher risk side; see next.
ALTERNATE STRATEGY FOR ABOVE: Convert the option-purchase into an actual purchase via a cash purchase or some type of financing. Then do a Reverse “Starker” 1031 exchange (with the Qualified Intermediary taking title to the replacement property). Here, you have a legal or equitable ownership into the property, as opposed to just contract rights. Now you are clearly exchanging real property. The longer you hold this legal or equitable ownership before the exchange, the better for purposes of qualifying for the exchange, with investment intent. For a further discussion of 1031 exchanges, see Chapters 32 to 34-A. For a further discussion of reverse “Starker” exchanges, refer to The 1031 Money Machine.

(2) Use a self-directed IRA to buy and sell the option. This is a great strategy! Here the option profit is totally tax-deferred or tax-free with a qualifying Roth.

(3) For other planning strategies to reduce, defer or eliminate taxes on the sale of property, see Chapter 31.

Reference Source (return tab): SAP 28

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. BASIC DEFINITIONS - “MASTER” or “SANDWICH” LEASES

B. TAX REPORTING FOR BUYER-OPTIONEE WITH SANDWICH LEASE-OPTIONS

C. MASTER (SANDWICH) LEASES SOLD TAX-FREE VIA A 1031 EXCHANGE

D. MASTER (SANDWICH) LEASES SOLD TAX-FREE VIA SDIRA

A. BASIC DEFINITIONS - “MASTER” OR SANDWICH” LEASES

A master or sandwich lease is a double-lease or subletting arrangement where the investor master leases (usually on a long term basis) the entire property from the owner and in turn sublets the property or units to another tenant(s) for a higher rental. The master lease with the owner must permit the investor to sublet the property. With master leases the investor can create a positive cash flow with little or no equity investment and without the complete responsibility of an “owner”. This creative investing and financing technique could work well with all types of properties – Residential rental and commercial. With a properly
structured master-lease-option, you are the *Buyer-Optionee-Lessee* with a lot of control.

## B. TAX REPORTING FOR THE *BUYER-OPTIONEE-LEASEE* WITH MASTER LEASE-OPTIONS

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. RENT DEDUCTIONS</td>
<td>Any rents paid by the buyer-optionee-lessee are deductible as “rent” for an investment property, as master leases are for investment properties, IRC 162(a)(3).</td>
</tr>
<tr>
<td>2. OTHER DEDUCTIONS</td>
<td></td>
</tr>
<tr>
<td>3. CAPITAL ITEMS</td>
<td></td>
</tr>
<tr>
<td>4. NO DEDUCTIONS FOR DEPRECIATION ON THE OPTIONED PROPERTY, ITSELF – YOU ARE NOT THE LEGAL OR EQUITABLE OWNER</td>
<td></td>
</tr>
<tr>
<td>5. NO DEDUCTION FOR “OPTION” PAYMENTS</td>
<td></td>
</tr>
<tr>
<td>6. ANY RENT INCOME RECEIVED BY BUYER/OPTIONEE IS ORDINARY INCOME</td>
<td></td>
</tr>
<tr>
<td>7. IRS REPORTING OF INCOME &amp; EXPENSES</td>
<td></td>
</tr>
</tbody>
</table>

### 1. RENT DEDUCTIONS

**NOTE:** Any mortgage payments on the optioned investment property paid by the buyer-optionee-lessee are deductible as rent as per the above. Frequently, when controlling investment properties via lease-options, the buyer-optionee-lessee will pay the property owner’s mortgage payment directly to the lender. This is done instead of paying the seller-optionor-lessee’s rent and then the seller-optionor-lessee (property owner) making the mortgage payment. *(Reason: So the buyer-optionee-lessee is assured that the underlying mortgage payment is being made on the optioned property.)* Because the buyer-optionee-lessee does not legally or equitably own the property, they are not entitled to the interest deduction on the mortgage (this stays with the owner as does the
deduction for property taxes). However, the buyer-optionee-lessee would deduct the full payment as *rent* as discussed above. The buyer-optionee-lessee’s payment of the mortgage payment is in effect rent income to the seller-optionor-lessee, because it is their obligation that is being paid by another party. (Note: This is all provided that the arrangement is a true lease/option as opposed to a disguised installment sale as discussed in Chapter 40-C).

2. OTHER DEDUCTIONS: Any other operating expenses paid by the buyer-optionee-lessee (such as repairs or maintenance) are also deductible. Other deductible operating expenses include:
Advertising, auto, travel, cleaning, supplies, insurance, legal fees, other professional fees, management fees, utilities, telephone, office supplies, postage, salaries, business publications, equipment rental, eviction costs, dues for investor associations, tuition for real estate seminars. For a list of other deductions see Chapter 23.

3. CAPITAL ITEMS: Any real property “improvements” (as opposed to deductible repairs) paid by the buyer-optionee-lessee are depreciated over 27-1/2 years for residential rental property and 39 years for non-residential property (see tip 1 below). They are not depreciated over the lease/option term.

**TIP 1:** Leasehold improvements for non-residential (commercial) real estate are depreciable over 15 years, straight-line depreciation. This could be subject to change, check with us.

**TIP 2:** Whether an expenditure is a depreciable capital improvement or a fully deductible repair is not always clear-cut. For planning strategies to convert improvements into deductible repairs, refer to Chapter 18). Any personal property (such as appliances) purchased by the buyer/optionee is depreciated over 5 years. For more about maximizing depreciation deductions via 5-year personal property, see Chapter 12. (Note: In this situation the seller-optionor-lessee (owner) would not be entitled to depreciate these items)
4. NO DEDUCTIONS FOR DEPRECIATION ON THE OPTIONED PROPERTY, ITSELF – YOU ARE NOT THE LEGAL OR EQUITABLE OWNER: With a true lease/option, while the buyer-optionee-lessee may have substantial control over the optioned property, they do not have legal or equitable ownership of the property, itself. Accordingly the buyer-optionee-lessee is not entitled to depreciation deductions on the optioned property, itself (except for any improvements or personal property paid by the buyer-optionee-lessee as discussed in number 3, above). Instead, it is the seller-optionor-lessee (owner) who would be entitled to these depreciation deductions. (This is provided that the arrangement is a true lease/option as opposed to a disguised installment sale as discussed in Chapter 40-C.)

5. NO DEDUCTION FOR “OPTION” PAYMENTS: Any “option” payments paid by the buyer-optionee-lessee are not deductible. Their tax treatment is discussed in Chapter 40-A.

   STRATEGY: If any portion of the option payments are truly lease or rent payments, then the lease portion is deductible as “rent” for an investment property, IRC 162(a)(3). On the other hand, the lease payments will be ordinary income to the owner, IRC 61(a)(5).

6. ANY RENT INCOME RECEIVED BY THE BUYER-OPTIONEE-LESSEE IS ORDINARY INCOME: With master leases, the buyer-optionee-lessee has the right to sublet the property and receive rent from a sub-tenant via the master lease.

   Any such rent received is reported as ordinary income by the buyer(optionee). However, such rent can be offset by the above discussed deductions.

7. IRS REPORTING OF INCOME & EXPENSES: The above income and deductions of the buyer/optionee are reported on the same IRS form for reporting income and expenses of any rental property such as Schedule E
C. MASTER LEASES SOLD TAX-FREE
VIA A 1031 EXCHANGE

If you structure a master lease with a 30 year term* or more (including lease extension), the sale of the master (sandwich) lease can qualify for a 1031 tax-free exchange.

*ALERT: It’s the remaining term on the lease that counts. Regulation 1.1031(a)-1(c) states this, “a leasehold of a fee with 30 years or more to run”. The emphasis on “to run” indicating that the lease term must be at least 30 years (including extensions) that is remaining on the lease at the time of the sale via the exchange, not the original term. So even if the original term (including extensions) was 30 years, but is less than 30 years at the time of the exchange, then the lease is not like-kind and the exchange would therefore not qualify. So the obvious planning is to make certain that at the time of the exchange (the closing of the relinquished property) the lease term is at least 30 years, or extend the lease term to be at least 30 years.

EXAMPLE: Irene Investor (buyer-optionee-lessee) negotiates a 20 year term with a 15 year renewal option (total 35 years) on a master lease for a vacant office building in a prime location. She pays a below market master rental of $50,000 annually. Irene sub leases the offices to sub-lessees on a net lease basis for $125,000 a year. (“Net lease” is where the tenant pays for all expenses except perhaps property taxes and major capital improvements). Irene is “sandwiched” in the middle with an annual cash flow profit of $75,000 for the next 20 or 35
years (or more if there are extension clauses). Irene has created a valuable leasehold that can be sold or exchanged (with its 30+ year total term). If the $75,000 a year cash flow were discounted at a 15% yield over 30 years the present value of the discounted cash flows would be $492,000, rounded. (This leasehold could be worth more, we will use this for this example). Irene finds a buyer who pays $492,000. Because this is a 30+ year leasehold, Irene sells the leasehold interest, tax-free, via a 1031 exchange. Via the exchange, Irene uses the $492,000 as a down payment to purchase as replacement property an apartment building for $2,500,000 and with a great positive cash flow.

**NOTE:** Irene could have purchased as like-kind replacement property other types of property such as office buildings, strip centers, warehouses, storage facilities, even rental houses, or any combination thereof, etc.

### D. MASTER LEASES SOLD TAX-FREE VIA A SDIRA

A self-directed IRA is an alternative to doing a 1031 exchange and may even be superior because, if your self-directed IRA (SDIRA) master leases and sublets the property, than all cash flow from rents, other property income and resale profits go into the SDIRA, tax-deferred; or if a Roth IRA, permanently tax-free (once the 5 year/59-1/2 age requirements are met).

**MASTER LEASE-OPTION EXAMPLE VIA A SDIRA:** Sam (one of my students) master leased on a long-term basis an unfurnished 30 unit apartment building in a location accessible to the airport, train station and many major highways. The below market rent Sam paid was $400 a unit a month or $144,000 a year. Because of its accessible location, Sam knew there was a demand for nicely furnished apartments. So Sam tastefully decorated and furnished the units and eventually sub-leased them for $1,200 a month or $432,000 a year. The
operating expenses were $100,000 a year. Consequently, Sam generated a healthy
annual positive cash flow of $188,000 (which is gross rents received of $432,000
less rent paid 144,000 less operating expenses 100,000). A leasehold with this
amount of positive cash flow could be sold for at least $1,000,000 or even more.
The entire annual cash flow of $188,000 along with the $1,000,000 resale profit
can be totally tax free within the SDIRA. If the $188,000 within the IRA was
invested at 10% annually for 10 years it would grow to almost $3,000,000 tax-
free. If at the end of 10 years, the master lease is sold for a $1,000,000 (probably
be a lot more), the SDIRA would have almost $4,000,000 ($3,000,000 +
$1,000,000). If the $4,000,000 just sat there in the SDIRA at 10% for another 10
years, it would grow to over TEN MILLION DOLLARS, TAX-FREE!!!

PLUS (as if the 10 million was not enough!) - There are several significant
advantages to using an SDIRA for master leases:

1. It is very doable, even with new IRA’s with limited funds. This is because
master sandwich leases generally do not require significant down payments as in
the case if the property were purchased. Usually master leases can be secured with
relatively small security deposits or advance rental deposits, yet create substantial
net cash flow as demonstrated by this example.

2. Because you (as buyer-optionee-lessee) are not the legal or equitable owner of
the property, you cannot claim depreciation which often totally shelters cash flow
and even creates a “paper” tax loss especially with component depreciation. But
your IRA can shelter net cash flow without depreciation with these master leases.

3. A master lease, properly structured as such, is not considered any type of
financing. Therefore no part of the IRA will be taxed as in the case of a recourse
(personal liability) mortgage under prohibited IRA transactions. That is, if the
SDIRA purchased the property with a recourse mortgage (personal liability), the
applicable portion of the IRA would be taxed. Alternatively, if the SDIRA
purchased the property with non-recourse financing, such as a subject-to, then the
SDIRA could be subject to the unrelated business income tax (UBIT). With a master lease none of this happens.

Reference Source (return tab): SAP 29

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
40-C

Alert On Lease-Options As Disguised Installment Sales -- Planning Strategies

Reference Source (return tab): SAP 30

In this chapter we will cover the following:

**A. TAX CONSEQUENCES IF A LEASE-OPTION IS DEEMED A DISGUISED INSTALLMENT SALE AND THUS A COMPLETED PURCHASE AND SALE - (If This Happens There Is No Lease-Option).**

1. TO THE TENANT-BUYER-OPTIONEE – NOT SO BAD

2. TO THE LANDLORD-SELLER-OPTIONOR – COULD BE BAD:

**B. INDICATIONS OF WHEN A LEASE\OPTION IS A COMPLETED SALE**

**C. STRATEGIES TO AVOID RECHARACTERIZATION OF A SALE**

**A. TAX CONSEQUENCES IF A LEASE-OPTION (MASTER-LEASE) IS DEEMED A DISGUISED INSTALLMENT SALE AND THUS A COMPLETED PURCHASE AND SALE**

(If This Happens Then There Is No Lease-Option).

1. TO THE TENANT-BUYERE – NOT SO BAD:

The lease payments are non-deductible, *Beus*, 28 TC 1133, aff’d, 261, F. 2d 176. If the property is a rental or business-use property, the buyer will be entitled to depreciation and other property expenses. Also, part of the monthly payments may
be allocable to deductible interest, *Wilshire Holding Corp.*, 262 F.2d 51; Revenue Ruling 72-408.

Therefore, the combination of deprecation, property expenses and perhaps interest may approximate the amount of lease payments (especially if you use my *Multi-Component Land Residual Method* for computing larger depreciation deductions. See Chapter 12).

**2. TO THE LANLORD-SELLER – COULD BE BAD:**

The tax consequences are generally more detrimental to the landlord-seller. First off, the seller will forfeit depreciation deductions as they are no longer the equitable owner. The lease payments will be part of the selling price. If the seller is not a dealer and the property has been held for the required holding period, the payments are capital gain (outside of imputed interest and any depreciation recapture, which are ordinary income). The landlord-seller, as an investor, can also elect installment sale reporting under IRC 453 (Chapter 35) and/or, for the cash portion of the arrangement, elect a 1031 exchange* (Chapters 32 to 34).

*ALERT*: Usually the cash portion (such as upfront deposits) in lease/options is not that significant. Therefore, if the lease/option is recharacterized as an installment sale, there will be little opportunity (if any) to do a 1031 exchange. *Reason*: The “paper” portion of the transaction does not qualify for a 1031 exchange; only the cash portion does.

**TAX BREAK ON LOSSES**: Any loss on the deemed sale would be ordinary for rental or business-use property, and capital for land held for investment.

**DEALER ALERT**: For a dealer*, the tax consequences of a gain are more severe in that there will be higher-taxed ordinary income and the ineligibility to defer taxes via installment sale, or a 1031.
**TAX BREAK ON DEALER LOSSES**: On the other hand, any dealer loss would be ordinary for both rental/business-use property and land.

**B. INDICATIONS OF WHEN A LEASE\OPTION IS A COMPLETED SALE**

1. **Payments Higher Than Market Rents** - The primary indicator that may cause the lease-option to be a completed sale is rent payments substantially higher than the fair rental value, along with a low option price, *Haggard*, 241 F.2d 288, aff’g 24TC, 1124l; *Truman Bowen*, 12 TC 466; *East Coast Equipment Co*, 21 TC 112, aff’d, 222 F.2d, 676.

1A. Large upfront deposits and/or final option payments can also be another indicator.

**EXAMPLE: Lease-option that is really a disguised installment sale**: CC does a 36 month lease\option on a $100,000 property which would normally rent for $1,000 a month. With the lease\option there are the following terms: $10,000 upfront option payment to be totally applied toward the purchase price; monthly payments of $2,200 of which $2,000 is to be totally applied toward the purchase price; $18,000 option payment to purchase the property at the end of the 36 months. The sum of the $10,000 option deposit, $2,000 rent credit for 36 months, and the final option payment of $18,000 equal the total purchase price of $100,000.

The $200 monthly payment not credited toward the price is presumably interest.

Although the *form* appears as a”lease-option”, this example demonstrates that the highly inflated rental forces this transaction to be, in *substance*, a completed purchase and sale at the time of the execution of the “lease-option”. See IRS Revenue Ruling 55-540. (Comment: This one is obvious!)
2. **Tenant-Buyer Substantial Improvements** - Another factor that could indicate a completed purchase and sale is where the lease requires the lessee (tenant-buyer) to make substantial improvements to the property and the lessee’s investment in the improvements can be recouped only by exercising the option, *Oesterreich*, 226 F.2D 798.

3. **Intent of The Parties** - Another factor is the intent of the parties, based on the facts and circumstances. If the parties can demonstrate that they believed the rent and option price to be reasonable, then the lease-option arrangement may hold up and not be a disguised sale. *Benton*, 197 F.2d, 745; *Lester*, 32 TC, 711.

**C. STRATEGIES TO AVOID RECHARACTERIZATION OF A SALE**

Where the parties want to avoid having the lease-option recharacterized as a sale, the overall planning strategy is to avoid or minimize the above indicators of a deemed sale as follows:

1. **Documented Fair Market Rent** - The rent should be at or near fair rental value. *Breece Veneer & Panel Co.*, 232 F.2d 319. Get a written opinion of the rental value from a qualified real estate professional (preferably local).

2. **Minimum Rent Credits** - Keep rent credits toward the option price to a minimum. Generally 20% or less is considered reasonable.

3. **Market Option Price** - The option price should be at or near fair market value. Get a written opinion of the market value from a qualified real estate professional. *Breece Veneer & Panel Co.*, Ibid.
4. **Lessee Improvements Not With Option** - Try not to tie-in substantial lessee improvements with the option exercise. (We assume “substantial” meaning some “insubstantial” improvements are probably OK).

5. **No Legal Or Equitable Title Transfer** - Do not pass legal (or equitable) title to the tenant-buyer.

6. **Intent To Do Lease-Option** – The parties are to demonstrate that they intend to do a lease-option and that they believe the rent and option price to be reasonable. See *Benton*, 197 F.2d, 745; *Lester*, 32 TC, 711. Use arm’s length lease-option documents that indicate such intent.

Reference Source (return tab): **SAP 30**

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. Recap of Option Types

1. Lease-option: You (landlord-seller or seller-optionor-lessee) already have purchased the property; you own it; you got the deed. You then find a tenant who wants to rent the property and have the option to purchase it at a later date for a specified price or a way to determine a specified price. You then lease-option the property to the tenant-buyer (or buyer-optionee-lessee) as discussed in Chapter 40.

2. Master-lease-option: You (buyer-optionee-lessee) do not purchase the property; you do not have the deed; you do not legally or equitably own the property. Instead you master-lease the entire property (in a multi-unit this includes leasing every unit). You also have the right (option) to purchase the property; the right to lease out (sublet) the entire property; the right to sell your option and leasing rights in the property to others, as discussed in Chapter 40B. While you do not have legal ownership, you have a lot of control, especially if you use and execute the proper legal documents (beyond our scope).
3. **Straight-option:** You (buyer-optionee) have the same type of option rights to purchase the property (as above), except there is no leasing either way – you are not a lessee or you are not a lessor; you are a *buyer-optionee*, period, as discussed in Chapter 40A.

**Disguised Installment Sale.** With the above, it is the lease-option and the master lease-option that are more prone to the disguised installment sale as discussed in Chapter 40C

**LEGAL ISSUES WITH OPTIONS**

Real estate options involve legal issues that you should be aware with. Such legal issues could also be state specific. So check with competent legal counsel, such as *Prepaid Legal* where you can save $1,000’s in legal fees (plus your time). Unlimited toll-free phone access to quality advice on any legal matter including calls or letters made for you; unlimited review of contracts (including options); representation in court if you are personally sued; IRS audit representation on your personal 1040; drafting or updating your will; representation for moving traffic violations. And in all states with quality law firms...for a low monthly (tax-deductible) fee!


**ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW**

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in
any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
The Significance In Tax Savings Between An “Investor” Vs. A “Dealer” - The Ultimate Controversy, Tax Law Guidelines, Planning Strategies

In this chapter we cover...

A. BASIC DEFINITIONS, ADVANTAGES, DISADVANTAGES
B. MAKING THE DISTINCTION? THE LONG, EVER PRESENT CONTROVERSY
C. CRITERIA AND GUIDELINES - WILLIAM MALAT TO THE RESCUE!
D. CRITERIA AND GUIDELINES - LIQUIDATION OF INVESTMENT
E. CRITERIA AND GUIDELINES - OTHER FACTORS
F. OVERALL PLANNING STRATEGIES FOR INVESTOR VS. DEALER

A. BASIC DEFINITIONS, ADVANTAGES, DISADVANTAGES

1. Basic Theoretical Definitions: 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” holds real estate as non-depreciable “inventory” for quick resale to customers in the ordinary course of business. The operations of a dealer are so extensive as to constitute a separate business, *Keeney* (1929) 17 BTA 560 (A).

2. **The Advantages of Being An Investor Are Superb!** Investors are entitled to:

   (1) Long-term capital gain, taxed at lower capital gain rates*
   (2) Exclude their gains from “active” income, subject to social security taxes.
   (3) Depreciation deductions, which create immediate tax saving
   (4) Defer taxable gains with the 1031 exchange and pay no taxes on the sale’s profits
   (5) Defer taxable gains with seller financing via installment sale reporting (IRC 453)
   (6) Use a capital gain to *fully* offset capital losses (ordinary income offsets only $3,000).

   *TAX POINTER: For purchased property, lower long-term capital gains results from holding the property for one year and one day. Therefore, if the property is held *less* than one year and one day it is taxed at the higher rates of ordinary income. In this case of a shorter holding period, an “investor” will not have this first advantage because they will pay the same higher rate of a “dealer”. However, the investor still has the other important advantages (2 to 6 above). Moreover, the real estate entrepreneur wants to try to set a precedent that they are an investor for future capital gain transactions involving property held for the required long-term holding period. In this case, the investor would have the added advantage of being entitled to the lower capital gain rate.

3. **The Disadvantages of Being A Dealer Are Severe!**
(1) Dealer property-profits (even long-term) are taxed at higher ordinary income rates. (For an individual, this is as high as 35% and before 2003 at 39.6%, or 40%, rounded.)

(2) Dealer property-profits are active income subject to social security taxes at about 15%

Note: When you combine (1) and (2), you have a total federal tax rate of over 50%!

(3) No valuable depreciation deductions.

(4) Dealer-property profits cannot be tax deferred with a 1031 exchange. Not being able to do an exchange could substantially deplete equity as well as interfere with investor goals.

(5) Dealer-property does not qualify for installment sale reporting under IRC 453. Yes, even if the owner does not receive the cash and, instead, takes back a note on the dealer-property sale, they are still taxed on the entire non-cash (“phantom”) gain. This dealer disadvantage could be a detriment to creative seller financing which has numerous advantages for both the buyer and seller. In fact, this drawback could altogether prevent the sale of the property. For installment sale reporting, see Chapters 35 to 39.

(6) Dealer-property does not qualify for the full offsetting of capital losses against gains. Capital losses (such as from the sale of stocks) are deductible against ordinary (dealer) income only in the amount of $3,000 per year. However capital losses can fully offset capital gains. Dealer profits are considered ordinary income and not capital gain. Accordingly, dealer profits place a $3,000 limit on the deductibility of capital losses.

The only dealer advantages are: (1) Dealer operating losses are not subject to
passive loss limitations. (2) A loss on the sale of dealer property (including land) is a fully deductible ordinary loss, not subject to the limitations of capital losses on the sale of land, held for investment. However, investors can reap at least some of the same advantages.

In short, without planning, **being a dealer can be a tax disaster, which could tens of thousands in taxes!**

4. The More Obvious Examples of Who Is An Investor Verses Who Is A Dealer: An investor may typically be someone who has a full time job (often unrelated to real estate), but who also buys income property, holds it for a number of years, depreciates it, and later sells (or exchanges) the property. On the other hand, a typical dealer is a full time builder/developer who holds real estate as non-depreciable “inventory” to be quickly sold to customers in the ordinary course of their “turnover” business. In one case the taxpayer resigned from his job and exclusively devoted his time and energy to the residential development of property. He entered into contracts for the construction of homes. He controlled the size, quality and sales price of the homes and lots. He negotiated with buyers and attended closings. His exclusive, extensive and full time activities into developing & selling made him a dealer, *Gibson*, TC Memo 1981-240.

Note: Apparently, *Gibson* did no planning to avoid dealer status or minimize dealer disadvantages. Planning strategies are discussed in the next two sections

**B. MAKING THE DISTINCTION? THE LONG, EVER PRESENT CONTROVERSY**
The Ever-Present Controversy - While the distinction may appear theoretically clear, practically, there is an ever-present controversy of whether a taxpayer is an investor versus a dealer. The above are only obvious examples. But what about someone who first enters the real estate business and buys & sells 5 houses for the year. Are they a dealer? Or someone who occasionally subdivides ground and sells off some parcels. Are they a dealer?

Typical Scenarios: Or someone who has been in the rental business, decides to liquidate and sells off a number of properties in a short time. Are they a dealer? Or someone who buys a duplex at a seashore resort, converts the property into 2 condos and sells off the 2 condos. Are they a dealer? Or someone who buys on old house, knocks it down, builds 4 condos, lives in one and sells the other 3. Are they a dealer?

Not Clear-Cut: The answer to the above is anything but clear-cut and will depend on a number of facts and circumstances discussed in this section and Appendix E on disk. Between the more obvious examples (above) is a vast gray area of controversy as this has been a heavily litigated area involving almost 400 cases, mainly since the late 1940’s to the present time. (Included here is one favorable 1966 Supreme Court case, discussed later). This is an astronomical number cases for such a very narrow area of the tax law.

Inconsistent Court Decisions: Decisions have gone both ways and have been inconsistent in their findings with virtually every factor or aspect of the issue being challenged (see the next paragraph). Many of these cases have had very similar facts; yet in one case the taxpayer was a dealer, while in another they were an investor. For instance, cases involving one sale have lead to dealer status, while others, involving numerous sales, have lead to investor status. Also, many of these disputes never make it to the courts but are resolved at the IRS examination, again going both ways. We hear about these disputes at the IRS examination level from tax advisors or the taxpayers themselves.
**Factors:** However, most of this area of tax law is based on the large number of inconsistent court decisions. Based on the many court decisions, the following factors*, that help to decide if you are an investor or dealer, have been argued with decisions going both ways: Intent for holding property; number & frequency of sales; time and effort in buying & selling; extent of improvements made; length of time property was held; other sources of non-real estate income; extent of advertising & promotion of property sales; where the taxpayer is also a licensed real estate agent; where there is both investor and dealer property; reasons for selling; subdivisions, condo conversions and others. Sometimes these disputes never make it to tax court and are resolved at the IRS examination level with the same inconsistency. (*For a further discussion and analysis of these factors, see Appendix E on disk, PAPPE).

**Two-Face IRS:** Moreover, with this issue (as with other controversial areas), the IRS pulls their “reverse two-face” ploy when it is to their benefit to argue for investor status, instead of dealer status. They have done this in numerous cases - *Schwartz*, TC Memo 4/25/51, 10 TCM 400; *Boynton*, TC Memo 1969-204; *Terry*, TC Memo 1984-442; *Pettit*, TC Memo 1997-438.

**Reason:** These cases involve the scenario where the property (usually land) is sold at a loss. Land held as investment is a capital asset. Therefore, if the property is land, the loss of an investor is a capital loss which is limited in that it is deductible against ordinary income only in the amount of $3,000 per year. Also, while you can carry forward a capital loss, it cannot create or increase an NOL or Net Operating Loss (discussed in Chapter 28). But the loss on the sale of any dealer property (including land) is an ordinary loss and fully deductible without limit. Plus, such an ordinary business loss can create or increase an NOL.

Another point of IRS inconsistency is where the regulations address passive loss limitations as they pertain to dealer property. The regulations appear to effectively admit that “property held for sale to customers” could be treated as non-dealer property, Reg. 1.469-2T(c)(2)(v).
The Bottom Line About This Controversial Issue: This issue is best described by a court and its opinion which stated: “This controversy brings before us the old, familiar, recurring, vexing and oft-times illusive problem of whether to treat profit arising out of sales of sub-divided real estate as capital gains or ordinary income.” *Biedenharn Realty Company Inc.* vs. U.S., 526 F2d 409, Revg 509 F2d 171. Based on the above, it is the author’s opinion that the issue of “dealer vs. investor” is the most controversial and grayest area of all tax law (not just real estate). Very little is carved in stone. It is a very arbitrary question of fact, where real estate entrepreneurs can (and should) be decidedly aggressive and astutely creative. They should do so, by planning in advance of transactions; using the Goldmine strategies; avoiding incompetent tax preparers!

C. CRITERIA AND GUIDELINES - 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 based on the factors discussed in this section and Appendix E. Thus, many cases before 1966 were not in the taxpayer’s favor (dealer), while more cases afterwards were in their favor (investor). In *Malat* the Supreme Court further clarified IRC 1221(1) by stating that property is held “primarily” for sale to customers when that is the principal purpose. That is, when it is of “first importance” or “principally” (emphasis added). The sale to
customers must be the chief purpose. Before *Malat* the IRS had this view - if property is acquired for rental or other investment purposes, but the owner also plans to sell the property (if the original plan becomes unfeasible), then he still holds the property as a dealer. Fortunately, the Supreme Court in *Malat* rejects this IRS viewpoint.

Thus, before *William Malat* even if selling a property to customers was one of several other options (such as long-term investment or rental), you still could be considered a dealer, even if selling was not necessarily the primary alternative. With *Malat*, the chances for dealers to attain favorable investor status has 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. It is not sufficient if the sale to customers is one of two or more alternatives. Therefore ordinary income does not result if a sales purpose is substantial but not dominant, *Municipal Bond Corp*, 341 F2d 683, 1965. That is, if the taxpayer can demonstrate that another 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 of law. All courts and the IRS must abide its decisions. Since *Malat*, the courts have adopted three additional tests that have generally led to investor status: (1) The amount of gain, (2) The reluctance of sale, and (3) Liquidation of investment (or changed circumstances). Numbers 1 and 2 are discussed in Appendix E and number 3 is discussed next and in **Appendix E**.

**D. CRITERIA AND GUIDELINES - LIQUIDATION OF INVESTMENT**
Liquidation of investment is a defense against dealer status. Using this argument, property owners (especially “dealers”) argue that they had the requisite "investment" intent, but there were factors & circumstances beyond their control that forced them to liquidate quickly. The argument maintains the premise that why the owner should be penalized with the “dealer taint” because of factors beyond their control? It can be (and has been) a powerful defense for favorable investor status. For a further discussion of liquidation of investment, with case law citations, see Appendix E.

E. CRITERIA AND GUIDELINES - OTHER FACTORS

To help a taxpayer determine which factors are most important in the investor/dealer classification process. A comprehensive analysis on the topic is contained in Appendix E. This appendix should be reviewed before going any further with this issue.

F. OVERALL PLANNING STRATEGIES FOR INVESTOR VS. DEALER

Our planning strategies will fall into two main categories:

I. FOR INVESTORS, TO COMPLETELY AVOID DEALER STATUS.

II. FOR DEALERS, TO MINIMIZE DEALER DISADVANTAGES OR REGAIN INVESTOR STATUS.
These planning strategies are discussed in the next several chapters.
Primary Strategies How Investors Can Totally Avoid Dealer Status

This chapter includes the most powerful ways to totally avoid being a dealer with tax law citations. We will cover the following...

A. PRIMARY STRATEGY I: INVESTMENT INTENT WITH WILLIAM MALAT

B. PRIMARY STRATEGY II: DEMONSTRATE AND DOCUMENT LIQUIDATION OF INVESTMENT (Statement of Investment Intent)

C. PRIMARY STRATEGY III: COMBINE I AND II WILLIAM MALAT WITH LIQUIDATION OF INVESTMENT

D. A NON-MALAT DEALER AVOIDANCE STRATEGY

E. CONDO CONVERSIONS

F. THERE HAS NEVER BEEN AN ISSUE OF CIVIL OR CRIMINAL FRAUD WITH THE ISSUE OF INVESTOR VERSUS DEALER

G. ACTUAL CASE STUDY - TOTAL DEALER AVOIDANCE

[TAX NOTE: This issue is usually decided on a property-by-property basis, instead of an individual-by-individual basis. Harbour Properties, Inc., 32 TC Memo 580 (1973). That is, a taxpayer can be an investor to certain property and a dealer to other property.]

A. PRIMARY STRATEGY I: INVESTMENT INTENT WITH WILLIAM MALAT

Convert or reclassify any potential dealer property into property held (or
intended to be held) as “investment” property and prove that dealer intent has been dispensed with, or really never began. In essence, apply the Supreme Court Case, *William Malat*, by demonstrating that your purpose in holding the property is also for rental or investment purposes (other than selling). However, in arguing *Malat*, the burden of proof is on the taxpayer to demonstrate that property is acquired for “investment”, *Baris* TC Memo 1965-182.

Doing this requires a series of advanced planning strategies following *Malat* as follows.

1. **Take the firm position you are a not dealer** (both verbally or certainly in writing). Do not hold yourself out as a “dealer” or “trader” to the public [see *O’Donnell*, where the taxpayer admitted he was engaged in the business of selling the houses (1959, 31 TC 1175)]. Get the “dealer” word out of your vocabulary. There is no “license” or document tagging someone as a real estate dealer. There is no definition of a “dealer” in the internal revenue code. There is no special IRS “dealer” form to use or a “box” to check off.

2. **Do not make admissions on your tax return, or anywhere else**, such as accounting records or LLC minutes [This is what *Hyslop* did wrong, see *Hyslop*, DC-FL, (1969), 23 AFTR 2d 69-1587]. On your tax forms, use a principal numerical business code that describes your business activity an investor. See-audit proofing strategies, in the next chapter.

3. **Create the paper trail that you have “investment intent”** by using *The Statement Of Investment Intent* (contained in this chapter). *The Statement Of Investment Intent* should be included in your LLC operating agreement and minutes or resolutions.

3A. **Avoid** words such as “development”, “sale”, “sell”, “flip”, “wholesale”, “retail”, “subdivide”, “subdivision”, “dealer”, “trader” “turnover”, “inventory”, or any other words denoting intent to sell. In one case a change in the partnership agreement allowing it “to own, buy, sell and trade in real and
“personal property” convinced the court that there was a change to dealer intent [Hansche v. Com., 72-1 USTC ¶ 9301, affg TC Memo 1970-342]. (Bold emphasis added).

4. Create the paper trail of investment intent in other documents. Such as in your purchase and sales agreements and designate the property as an investment on the books [Sanford Homes Inc, TC Memo 1986-404]. For example, in the purchase agreements (probably an addendum) insert this. “Property is being acquired for investment purposes”. In your accounting records (like QuickBooks) insert “Investment-only properties”.

Note: The best documentation to support investor status is that which is obtained at the time the events occur and not when the issue is subsequently addressed. (But do it anyway)

5. Maintain investment intent by using the consolidated entity strategy where you have your quick sale non-dealer flippers and your rental keepers in the same LLC-partnership so the keeper investment intent overrides the sales intent of the flippers. Do not use a separate entity for flips as this causes you to be a dealer because then with a separate entity soley for non-dealer flips you have a sales intent instead of an investment intent (sales intent = dealer; investment intent – investor) You get investment intent with the consolidated entity strategy. For a further discussion see Ch. 6.

6. Hold the “investor” property for as long as possible. The longer the better for attaining investor status (Note: But the amount of time held is not carved in stone as a deciding factor).

7. Try to overlap the holding period of a property into two different tax years. With this strategy even a very short holding period will show that the property has been owned on two years of tax returns.
8. If the property is a rental property (such as a house, apartments or offices) then rent it, or demonstrate that you attempted to rent it, even if the holding period is a short one.

Supporting case law: Besides Malat and the above cases, there is substantial and specific case law to support this strategy. In the following cases the rental property was held for investment purposes and the taxpayer was allowed capital gain treatment on the sale of the property:

In Peter R. Shibley* the tax court stated that a sale soon after completion of a property may receive investor treatment if the primary intent is to rent rather than sell (*30 TCM 597 9, 1971). (Bold emphasis added).

Properties were sold to tenants who were given an option to buy the property leased to them, Vivian Smith v. Com., (1956, CA5) 232 F2d 142, 49 AFTR 874, 56-1 USTC ¶ 9436.

- Taxpayer, who ordinarily financed construction of houses for sale on short-term loans, built 13 units with long-term financing and held them for rent before selling them, Roy Self, TC Memo 5/26/50, 9 TCM 421.

- Sale of rental property by a builder who did not actively engage in selling the property, even though many houses were sold within a relatively short period, Victory Housing No.2 Inc., (1953, CA10) 205 F2d 371, 44 AFTR 80, 53-1 USTC ¶ 9446.

- A builder, who liquidated rental housing, claimed he did not actively enter into the real estate business for purpose of selling the houses, Dillon v. Com., (1954, CA8) 213 F2d 218, 45 AFTR 1558, 54-1 USTC ¶ 9429, revg TC Memo 3/30/53,12 TCM 338.

- Substantial sales in liquidation of a rental business, Donner, TC Memo 11/27/53, 12 TCM 1335, aff'd on other grounds (1955, CA2) 227 F2d 381, 48 AFTR 435, 55-2 USTC ¶ 9782; [See also Warr v. U.S., 7/27/53, DC-OK, 48 AFTR 1252, 54-1 USTC ¶ 9198; Lockwood v. US, 10/14/53, DC-TX, 44 AFTR 1295, 53-2 USTC ¶ 9575; Crabtree,
9. In renting the property, it strengthens your case if the leases are written and not verbal. Rubin, TC Memo 12/28/49. (Note: This is also imperative for legal and management purposes; so do it!).

9A. Make the leases as long-term*as possible. Andrew Tell Investment Co. v. Com (1973, CA9) 473 F2d 1031.

[*Investor Tip: With a longer term lease, you can always have an escape clause allowing you to legally break the lease.].

10. For a rental property claim depreciation, even for a short holding period. Reason: Not to claim depreciation under IRC 168, could be construed as an admission of dealer status. As inventory, dealer property is not depreciable; but property held for “investment” is. You should report it as a rental property on the appropriate IRS rental schedule and depreciation schedule (IRS Form 4562).

11. If the property is not actually rented, then document attempts to rent it by way of newspaper ads, “for rent” signs*, the internet, listing contracts, flyers, etc. (*Take a photo of the rent sign and date the photo.)

12. If the rental property is not actually rented, then make an audit proofing statement behind the rental property IRS form. For a sample, see the audit-proofing strategies in the next chapter.

NOTE: Holding property as rental property is no guarantee. There are several cases where the rental property was held for sale to customers and the profit on the sale of the property was taxed as ordinary (“dealer”)
income: Houses were rented to tenants with an option to buy, Meridian Inc., TC Memo 1962-56; Wartime housing was rented but the builder made considerable efforts to sell the buildings to the tenants, King, TC Memo 2/28/50, 9 TCM 135; A real estate broker bought and sold rental property within a short period (7 out of 10 properties purchased were sold within two months). Field, TC Memo 2/23/49, 8TCM 170; The taxpayer sold lots which were bought for investment; he never converted them into property held for sale, Meyer, TC Memo 1955-47; Malouf, 2/28/52, DC-CA, AFTR 942, 52-1 USTC ¶ 9296.

IMPORTANT TAX BREAK: As per the bold emphasis, all of the above cases were before the 1966 William Malat Supreme Court case. Thus using the above planning strategies will be much more effective with Malat now on our side.

WM Malat Strategies Specifically for Land

13. If the property is land, you can especially apply Malat by demonstrating that your purpose is to hold the property for investment purposes (other than selling). Hold the property as long as possible, doing little development as possible.

14. If the property is land, you could also hold the land out for rental such as for advertising billboards, farming, recreational, or as a future building site for rental as in one case*.

*In this case, certain lots from a subdivision were not originally intended for sale, but for a future shopping center for rental income. However, they were ultimately sold without the dealer taint, Reppell, TC Memo 1961-53. (Bold emphasis added). (Note: Even though this is pre-1966, the favorable decision of this case is William Malat in the making!) Moreover, just because you expect that the property will increase in value does not mean you are a dealer, Reg. 1.1031(a)-1(b).

Other Secondary Malat Strategies

15. Where practical, minimize time and effort in selling real estate. This
can be done by keeping advertising at a minimum or by selling or advertising through an independent real estate broker. For this strategy to be most effective, the relationship between the investor and broker should be as independent as possible, using arm’s length agreements. (The less effort you put in, the better your argument for being an investor and not a dealer. But this is certainly not the only factor.)

16. Where practical, frequency and number of sales should be kept to a minimum in any one tax year. Separating sales from one year to another may also help in this situation.

**NOTE**: At first glance you may think this should be a primary strategy and perhaps in some respects it may be, because if you can practically do this strategy, then do it. But remember our primary focus here is total avoid dealer avoidance even with a large number of sales transactions in one year.

17. Improvements to the property should be reasonable. “cosmetic” improvements, instead of substantial structural improvements. (Note: This has the additional advantage of being in a better position to reclassify capital improvements into fully deductible repairs as per Chapters 17 to 19-A. But this is not the only factor).

**NOTE**: With wholesaling there are generally no improvements made by the investor. With rehab flips, there are improvements (often substantial). However they generally are not structural; plus they are to enhance investment value with the Statement of Investment Intent.

18. Try to do as little development to the “investor” property as possible. (Note: “soft” costs, such as engineering, architectural, zoning approvals, etc., are indicative of development. On the other hand they are certainly not the final factor).

**NOTE**: With wholesaling there are generally no improvements made by the
B. PRIMARY STRATEGY II: DEMONSTRATE AND DOCUMENT LIQUIDATION OF INVESTMENT (Statement of Investment Intent)

Liquidation of investment is a defense against dealer status. Using this argument, property owners (especially “dealers”) argue that they had the requisite "investment" intent, but there were factors & circumstances beyond their control that forced them to liquidate quickly. The argument maintains the premise that why should the owner be penalized with the “dealer taint” because of factors beyond their control? Thus, even where entrepreneurs purchase property with the original intent to sell to customers in the ordinary course of business and there were extensive selling activities, they can still be investors. They can do so provided that they can prove that, because of certain “liquidating factors” beyond their control, they were “forced” or “pressured” to sell or exchange and liquidate their investments. It can be (and has been) a powerful defense for favorable investor status.

Specific Strategies: The specific strategies are to document that you come under one or more of the following liquidating factors or reasons, that have contributed to the taxpayer’s success in achieving favorable investor status:

1. Pressure from creditors, and lacked expertise or means to develop property. Lomas & Nettleton Financial Corp. (180, DC Tax) 488 F. In another case investor status was attained where the taxpayer sold 67 subdivided lots over six years in order to pay debts, Dressen, (1952) 17 TC 1443(A). (Emphasis added)


8. Special or changed market conditions. *Pontchartrain Park Homes, Inc.* 349 F2d, 416, affg TC Memo 1963. This is one that could be used frequently because the real estate market could be subject to changes.

In one case the taxpayer was a partnership engaged in developing tracts of real estate for sale to customers. They also built 194 duplexes for rental. When it was determined that there was a poor rental market, the taxpayer actively sold the duplexes. The Ninth Circuit reversed the tax court’s decision and allowed investor status, because the property was disposed of as a “liquidation” of an investment. This was so even though the evidence supporting the taxpayer’s contention that the sale was for liquidating purposes was less than overwhelming. Such evidence was nevertheless sufficient to afford the taxpayer capital gain treatment, *Heller Trust*, 382, F.2d 675 (1967). (Notice that this is a post 1966-Malat case.) Investor status was allowed in the sale by a real estate dealer of 19 rentals properties in one year and 27 in another year because of rent control and high prices. *Farry* Ibid. In another case the taxpayer was in the business of
constructing houses for sale. When the **sales market disappeared**, the taxpayer rented the houses in an attempt to salvage a return until they could be sold at a profit. The Tax Court, citing *Malat* as requiring a determination of the “primary purpose” for which the property was held, treated the sale as the liquidation of an investment, *Scottwood Development Co.*, 26 TC Memo, 855 (1967) {Post ‘66).

**Note**: In *Scottwood* the taxpayer proved *Malat* as the IRS could not establish that the taxpayer’s chief purpose was to sell to customers in the ordinary course of business.

A builder had sold 6 homes over a 2-year period. He had built these homes to hold as rental units and sold them only because **market conditions were more favorable for sale than rental**, *Sweeney*, TC Memo 1964-324. See also *Dillon v. Com.*, 213 F.2d, 218 for changed conditions requiring “liquidation”.

Most of several hundred lots were disposed of in bulk in what was virtually a single sale at a price considerably **below the price** obtainable by selling the lots separately, *Tibbals*, TC Memo 1958-44. (Bold emphasis added in the above cases)

9. **Unsuitable for particular purpose(s), making it impractical to proceed.** *Est. Dean*, TC Memo 1975-137. In another case a real estate developer sold lots within a larger tract where he considered the lots unsuitable for residential use at the start, *Pasadena Investment Co.*, (1963, DC TX) 223 F Supp 639, 12 AFTR 2d 5683, 63-2 USTC 9767.

10. **Financially unable to continue as planned.** *Dahlstrom*, TC Memo 1968-197. In another case the taxpayer made land sales which were forced by unexpected financial reverses to sell its business, *Jersey Land and Development Corp v. US*, 3/21/75, DC-NJ, 35 AFTR 2d 75-1157, 75-1 USTC 9386.

11. **Poor health.** *Lowery*, TC Memo 1964-30. In another case, the taxpayer had to sell because they were in ill health and anxious to set their business interests
in order, *Pasadena Golf Course Inc.* TC Memo 1975-237. Thus, sudden ill health could cause a developer to retire from business. Because of this external event beyond the control of the taxpayer, investor capital gain would probably be permitted, despite the fact that dealer (developer) property is being sold. (Don’t rush this one!)


13. **Death of major principal.** *Simmers & Son, Inc.*, TC Memo 1968-150. (Please...don’t rush this one!)

14. **Building or zoning restrictions.** Property acquired for building as rental investment was sold in a number of separate sales because the sales were forced by building restrictions, *Lobello v. Dunlap*, (1954, CA5) 210 F2d 465, 45 AFTR 337, 54-1 USTC ¶ 9234. When zoning restrictions prevented construction of a proposed hotel, unimproved real property was sold in 12 parcels. *Edwards, P.*, TC Memo 9/10/53, 12 TCM 1045.

15. **Property acquired by inheritance.** *John R. Hopkins*, 15 T.C. 160. Property acquired with no intent to own it, such as through inheritance or bequest, has a better chance of being investor property, even if improvements enhance the salability of the property. A trust sold 17 parcels in one year. All of the properties were received as a gift, held for appreciation and inactively sold, *Schwerin, Helen Trust*, TC Memo 3/11/54, 13 TCM 202.

16. **Condemnation or threat of condemnation.** Property admittedly held for sale to customers can receive capital gain treatment where there is a condemnation or threat of condemnation*. *Tri-S Corp*, 68-2 USTC 9541; *Ridgewood Land Co. Inc.* TC Memo 1972-16, *Fabiani*, TC Memo 1973-203; *Biedermann*, (1977) 68 TC1.
*STRATEGY*: Use *Involuntary Conversion* (IRC 1033) to defer taxes on the gain - Here, gain is realized from compensation from government condemnation. This provision (IRC 1033) can defer taxes on gain if certain tests are met, including the need to acquire replacement property within a certain time period. See Chapter 31, IRS Publication 544 and IRC 1033 for a further discussion.

17. Property disposed of through foreclosure. The tax law says that a gain (or loss) is recognized on the sale or “disposition” of a property [IRC 1001]. A regular sale of property is not the only type of “disposition” and is therefore not the only way to incur a gain. Another type of disposition that could result in a gain is the foreclosure of a property. The sales price (or “amount realized”) would be the amount of debt relieved. If the debt relieved exceeds the tax basis of the property, then there is a taxable gain. However, unlike most normal sales, where there is cash to be received, a foreclosure disposition results in an old nemesis, *phantom income*, which is non-cash income, but is still taxable. In the following cases the taxpayer’s gain on the foreclosure was taxed as capital gain and not ordinary income, *Penman*, 4/9/57, DC-FL, 52 AFTR 1686, 57-1 USTC; *Ayling*, (1959) 32 TC 704(A); *Loewenberg*, TC Memo 10/11/48, 7 TCM 702; *Lloyd v US*, 6/12/61 DC-WA, 8 AFTR 2d 5586.

18. Other. And any other similar types of circumstances that are beyond the control of the taxpayer. For example, partners in business of managing real estate for the production of income, sold certain real estate in order to raise cash to cover losses in an unrelated business, *Martin v. U.S.*, (1954, DC GA) 119 F Supp 468, 45 AFTR 734, 54-1 USTC ¶ 9157.

**Recap of the Liquidation Of Investment Theory:** In short, capital gain treatment and investor status might be available where the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continued pre-existing use of the realty. The court stated that “…Acts of God, condemnation of part of one’s
property, new and unfavorable zoning regulations, or other events forcing alteration of taxpayer’s plans create situations making possible subdivision and improvement as part of capital gains disposition.” The court cautioned, however, that although it might permit an owner substantial sales flexibility where there is a forced change from original investment purpose, it won’t absolutely shield a taxpayer from ordinary income. A taxpayer isn’t granted carte blanche to undertake intensely all aspects of a full-blown real estate business. *Biedenharn Realty Company Inc. vs. U.S.*, Ibid.

**IMPORTANT:** The liquidating reasons should be clearly demonstrated in all documents such as LLC operating agreements, minutes, correspondence, etc. Failure to do so could result in dealer status as the burden of proof is on the taxpayer, *Ferguson*, TC Memo 1987-257.

**TAX ALERT:** The liquidation of investment defense loses its effectiveness if the investor subsequently acquires just flips, not keepers and does not reinvest the proceeds of the liquidation (at least in part) into the keepers*.

*STRATEGY:* In this situation, to increase the effectiveness of the liquidation of investment defense avoiding dealer status, the entrepreneur should be into long-term keepers in the same LLC entity as the flips (documented by the statement of investment) as per Chapter 6.

For a further discussion of liquidation of investment, with case law citations, see Appendix E

---

**STATEMENT OF INVESTMENT INTENT TO AVOID DEALER STATUS**

Reference Source (return tab): *SAP 23, Part B*

Document investment intent by incorporating below the fully documented *Statement of Investment Intent* in all of your records. Include a notarized copy of the *Statement Of Investment Intent* as part of the “Purpose” of your partnership agreement or LLC operating agreement. Include it in your LLC minutes. Send a copy to your tax advisor, attorney and Realtor. Attach it to your tax return.
Statement Of Investment Intent

As per the Supreme Court Case, William Malat (383 US 569), for all properties that I acquire it is my primary intent to keep the property for investment\rental purposes along with long-term capital appreciation. I will only the sell the property if my original and primary investment intent is changed by unanticipated events generally beyond my control. Examples of such events are:

**Need for working capital.** [Martin v. U.S., (1954, DC GA) 119 F Supp 468, 45 AFTR 734, 54-1 USTC ¶ 9157].

**Financially unable to continue as planned.** [Dahlstrom, TC Memo 1968-197; Jersey Land and Development Corp v. US, 3/21/75, DC-NJ, 35 AFTR 2d 75-1157, 75-1 USTC ].

**Special or changed market conditions.** [Pontchartrain Park Homes, Inc. 349 F2d, 416, affg TC Memo 1963.; Heller Trust, 382, F.2d 675 (1967); Scottwood Development Co., 26 TC Memo, 855 (1967); Sweeney, TC Memo 1964-324; Dillon v. Com. 213 F.2d, 218; Tibbals, TC Memo 1958-44; Farry 13 TC 8(A)].

**Pressure from creditors.** [Lomas & Nettleton Financial Corp. (180, DC Tax) 488 F. Dressen, (1952) 17 TC 1443(A).]

**Disagreement with Co-owners.** [Flose, Jr., TC Memo 1973-98]

**New investment plans.** [Maddux Construction Co. (1970) 54 TC 1278 ]

**Unsuitable for particular purpose(s), making it impractical to proceed.** [Est. Dean, TC Memo 1975-137; Pasadena Investment Co., (1963, DC TX) 223 F Supp 639, 12 AFTR 2d 5683, 63-2 USTC 9767.]

**Building or zoning restrictions.** [Lobello v. Dunlap, (1954, CA5) 210 F2d 465, 45 AFTR 337, 54-1 USTC ¶ 9234; Edwards, P., TC Memo 9/10/53, 12 TCM 1045]

**Disaster such as fire or flood.** [Tri-S Corp, 68-2 USTC 9541; Ridgewood
Land Co. Inc. TC Memo 1972-16; Fabiani, TC Memo 1973-203; Biedermann, (1977) 68 TC1]

Abandonment of investment plans, too costly. [Lowery, TC Memo 1964-30; Edwards Industries, TC Memo, 1974-120.]

Abandonment of real estate to go into other full time employment. [Vaughn, TC Memo, 5/14/48.]

Abandonment in a forced bulk sale and termination of the joint venture, [Silversmith v US, 12/5/78, 79-1 USTC 9117]

Property disposed of through foreclosure. [Penman, 4/9/57, DC-FL, 52 AFTR 1686, 57-1 USTC; Ayling, (1959) 32 TC 704(A); Loewenberg, TC Memo 10/11/48, 7 TCM 702; Lloyd v US, 6/12/61 DC-WA, 8 AFTR 2d 5586]


Property acquired by inheritance or gift. [John R. Hopkins, 15 T.C. 160. Schwerin, Helen Trust, TC Memo 3/11/54, 13 TCM 202]

Poor health. [Lowery, TC Memo 1964-30; Pasadena Golf Course Inc. TC Memo 1975-237]

Death of major principal [Simmers & Son, Inc., TC Memo 1968-150]

Respectfully and truthfully submitted: ________________________________

Notarized

Statement Of Investment Intent To Avoid Dealer Status (continued)
As per the Supreme Court Case, William Malat (383 US 569), this intent is further supported in that the resale properties are ancillary to the operation of my investment entity whereas the sole purpose of the resale property profits is not for sales speculation but instead to ensure the existence of the long-term investment keepers. More specifically the profits from resales are for the following investment necessities:

1. A “general working capital fund” for property investment operations including preventive maintenance.

2. An “emergency working-capital fund” for a property emergency, such as an unexpected large repair or extended vacancy.

3. A reserve for the periodic replacement of property components.

4. To upgrade the keepers. Modernize them for more market appeal. Consequently, attract higher-quality residents for even higher rents and long-term investment value.

5. To add additional facilities such as storage units, parking, laundry equipment, or tenant optional upgrades for more income further increasing investment value.

6. To pay down debt, especially high interest debt. My investment entity can end up owning properties with little or no debt in a shorter time enhancing investment value.

7. To invest in more properties for long-term investment and wealth accumulation.

8. To make paper investments such as discounted mortgages, tax lien certificates, structured settlements all long-term investment and wealth accumulation.

The overall purpose is that the keepers and resale properties are fused together to become one integrated economic investment unit.

Respectfully and truthfully submitted: ____________________________

Notarized

NOTE: Put this statement in your LLC operating agreement and minutes,
sign it and notarize it.

**C. PRIMARY STRATEGY III: COMBINE WILLAM MALAT WITH LIQUIDATION OF INVESTMENT**

Here, you apply *Malat* by demonstrating the primary purpose in holding the property is for *rental* or *investment* purposes. Then when you do sell, you document liquidating reasons (change of plans, market conditions, etc.) *forcing* you to sell, as previously discussed. This is a powerful investor defense, twice over.

**D. A NON-MALAT DEALER AVOIDANCE STRATEGY**

1. Consider alternatives to *selling* such as refinancing, longer-term lease options, estate transfers, exchanging*.

[*Note: IRS could consider exchanging the same as a sale for purposes of determining dealer status. However, “selling” instead of “exchanging” still would appear to give a stronger indication of dealer status. Therefore, it’s possible that exchanging itself could prevent dealer status. This can be supported by the underlying theory that 1031 exchanges represent a continuation of the taxpayer’s *investment*, versus dealing*.

**E. CONDO CONVERSIONS**

Entrepreneurs wanting to avoid being a dealer on condo conversions can use the strategies of this chapter. But there are also dealer avoidance strategies
specifically targeted for condo conversions. For more info email us with your R VIP code.

**F. 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 is on 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 *Goldmine* strategies; and avoid inept uncreative advisors (like the one in the case study at the end of this chapter).

**REMEMBER:** No one factor for deciding investor versus dealer status is controlling. *All* must be considered in relation to each set of *individual* facts & circumstances. See Research *Appendix E* for a further discussion.

**G. ACTUAL CASE STUDY - TOTAL DEALER AVOIDANCE**
1. **THE PROBLEM SCENARIO:** Pat is one of my students. He and his wife have full-time jobs unrelated to real estate. The previous tax year they just started to get into real estate and sold 5 properties that first year. Typically, Pat’s tax preparer “tagged” them as “dealers” and reported the property sales on IRS Schedule C (*Profit or Loss From Business*). This is the worst possible schedule because:

   (1) It blatantly admits that they are dealers,
   (2) It increases their chances of an IRS audit, and
   (3) It incurs the highest tax liability, especially with social security taxes.

Fortunately, the return was not yet filed. An examination of the facts indicated that Pat should not be a dealer.

2. **THE GOLDMINE SOLUTION:**

   (a) Eliminate Schedule C and remove the property as “dealer property”. Instead put them on IRS Form 1065 (partnership return) as “depreciable rental properties” (He and his wife can be partners. Pat can later form the partnership as an LLC for limited liability protection. Follow the other IRS audit-proofing techniques in the next chapter.

   (b) Hold the properties for rental and claim depreciation, even for short holding periods. (*William Malat strategies*).

   (c) **Immediately** fire the present tax preparer and engage a *competent real estate tax specialist*. (When I followed up with Pat, he decided to do his own taxes with the *Goldmine* and *TurboTax*. He had his full of inept and uncreative tax preparers)

   (d) In the future, follow the other recommendations in this chapter, as well as the audit-proofing strategies discussed in the next chapter.
3. THE POSITIVE RESULTS:

(1) We established Pat as an “investor”.

(2) We substantially reduced his chances of being audited, with no Schedule C.

(3) Saved him fees and poor advice by eliminating his idiot tax preparer.

(4) We substantially reduced his taxes by not having to pay Social Security taxes and lower capital gain rates if any of the properties are held for more than a year.

(5) Pat could zero out taxes on the sales with a 1031 tax-free exchange.

Reference Source (return tab): SAP 23
How Investors Can Audit-Proof Their Return Against Dealer Status – IRS Reporting

Reference Source (return tab): SAP 23, Part E

In this chapter we will cover the following...

A. AUDIT RISK - INVESTOR VERSUS DEALER - BACKGROUND

B. AUDIT-PROOFING TECHNIQUES

A. AUDIT RISK - INVESTOR VERSUS DEALER - BACKGROUND

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 investor vs. dealer was a hot IRS target. However, from 1987 until as a recently as 1993 the capital gain and ordinary rates were the same (or almost the same). During this period the issue cooled down quite a bit. Presently, there is about a 20% disparity between capital gain rates and ordinary income rates. Accordingly, the issue is starting to again attract some IRS attention, but not as much as before. What’s interesting to note is that the disparity of tax rates between capital gain and ordinary income has consistently been a top priority with IRS. Afterall, the main concern with IRS is taxing income at higher ordinary-income rates rather than lower
capital gain rates. Whereas, the ability to elect a 1031 exchange or installment sale, has generally been a secondary concern. (But subject to different individual scenarios). So, if the sale is for a property that is held less than the required holding period, the rates will be the same, regardless if it is “investor” property or “dealer” property. In this case the issue should not be a prime audit target. While the “investor” may not have the advantage of a lower rate, they still may have the other important advantages of an investor (such as 1031 exchanges, installment sale reporting or self-directed IRA’s). On the other hand if the property is held long-term, then the difference in tax rates could increase IRS attention. (Note: This all depends on the individual circumstances and the current IRS environment).

B. AUDIT-PROOFING TECHNIQUES

(1) IRS Reporting -- Avoid Schedules 1040-E or C altogether and file a partnership return-form 1065. This includes assignment flips. (See Chapter 5 for a further discussion of partnerships.)

Do NOT put assignment flips (or any sales) on IRS Schedule C. Put them on form 4797 as per the above. Reason: Using Schedule C is a direct admission you are “dealer”, along with having to pay employment taxes, plus Schedule C is very audit prone.

IRS Reporting Of The Sale Of Rental-Type Property, Such As Houses Or Apartments (Other Than Land): If the property is held less than one year and one day, report the sale as ordinary income on IRS Form 4797, page 1, part II, “Ordinary Gains and Losses. (Note that IRS Form 4797 is a supplemental schedule attached to a 1065 partnership return). Do the same for assigned contracts. Do NOT put assignment flips on IRS Schedule C. Put them on
form 4797 as per the above. **Reason:** Using Schedule C is a direct admission you are “dealer”, plus Schedule C is more audit prone.

If the property is held *more* than one year and **one day**, report the sale as a long-term capital gain (taxed at lower rates) on IRS Form 4797, page 2, part III, “Gain From Disposition of Property Under Sections 1245, 1250.” Also, use IRS Schedule D, “Capital Gains and Losses”, part II.

**IRS Reporting Of Land Sales** - If the land is held *less* than one year and **one day**, report the sale as a short-term* capital gain on IRS Schedule D, “Capital Gains and Losses”, part 1. If long-term, part II.

**NOTE - 1031 Exchange:** For any properties sold via a 1031 exchange, also use IRS Form 8824.

(2) **Do not make admissions on your tax return that you are a dealer.** Clearly indicate “investment intent”. **Avoid** words such as “development”, “sale”, “sell” “flip”, “wholesale”, “retail”, “subdivide”, “subdivision”, “dealer”, “trader”, “turnover”, “inventory”, or any other words denoting intent to sell.

(2A) **On your tax forms, use a principal numerical business code that describes your business activity as an investor.** Use the following: 531110 - Lessors of Residential Buildings & Dwellings, or 531120 - Lessors of Nonresidential Buildings (except Miniwarehouses), or 531130 - Lessors of Miniwarehouses, or 531190 - Lessors of Other Real Estate Property. **Do not** use: 531210 - Offices of Real Estate Agents & Brokers or 531390 - Other Activities Related to Real Estate. (The latter is too vague.)

(3) **You or your spouse (or both), list your occupation as “Property Manager” at the bottom of 2 of your 1040.** **Reason:** “Managing is akin to rental (investor) as opposed to selling (dealer). [This also helps to avoid passive loss limits per Chapter 26].
(4) If the property is not actually rented, then insert this audit reduction statement behind the rental property IRS form: *All of my deductions are legitimate and I have recordkeeping proof. I am an active real estate investor, who actively manages the property with the primary intent for profit as per Internal Revenue Code Section 183. If a property is not rented at any given time, documented and vigorous attempts are made to quickly rent the property in the way of newspaper ads, “for rent” sign, the internet, listing with a real estate agent, flyers, etc. Also, separate business records are kept. During any vacant period the property is not at all used personally by an owner or a related party as per Internal Revenue Code Sections 280A and 267(b).*

**NOTE TO USER:** You can also include reasons why the property is not rented (or for high expenses in relation to rental income) such as: *The rental market in this area has been slow, non-paying tenant, unqualified tenants, poor real estate market, illness, family problems, etc.*

**TIP:** Sign and have the above statement notarized for more credibility.

(5) Where practical, frequency and number of sales should be kept to a minimum in any one tax year. The less sales, the less to be audited on this issue.

(6) Consider alternatives to selling such as refinancing, longer-term lease options, estate transfers, etc. Again, the less sales, the less to be audited on this issue.

(7) In the infrequent full-time scenario where you will be a dealer, then follow the planning strategies in minimizing dealer disadvantages (discussed in Chapters 7A and 43). With this strategy, then there is no investor vs. dealer issue to audit.

Reference Source (return tab): **SAP 23, Part E**
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
How Dealers Can Minimize Dealer Disadvantages

In this chapter we will cover the following...

A. LIMITED TYPES OF REAL ESTATE ENTREPRENEURS.

B. SPECIFIC TAX PLANNING STRATEGIES

Based on the extensive research of this publication, my criteria of who a dealer really is very narrow. If your business is that of a full-time builder developer you are a dealer (barring any liquidating factors). If you are full time at flipping properties, do a very large number of flips annually, this is your primary business with the true intent to sell, and then most likely you are a dealer. Less than these scenarios, you could plan to avoid being a dealer based on my extensive research of the applicable law and the pertinent strategies from the Goldmine. Otherwise, read on.
B. SPECIFIC TAX PLANNING STRATEGIES

1. Clearly separate the investment properties from the dealer properties, where you will be a dealer with respect to some property, and an investor as to other property.

The dealer properties being sold should be separate from the ones being held for rental. The clearest way to accomplish this is to use separate entities with the “dealer” property in a limited partnership (as discussed in Chapter 7A) or another LLC and the “investor” property held an in LLC-partnership (as discussed in Chapter 5).

2. Only do the above separate entity approach for dealer sales. For non-dealer sales used the consolidated entity approach as discussed in Chapter 6.

In Chapter 6, the premise is that just because you start to flip properties, does not necessarily make you a dealer. This is based on the extensive research on this issue as contained in this publication. Consequently, with this “investor” position, we are instead consolidating the keepers and flippers in a single LLC entity where the keeper (investment) intent is dominate over the primary intent to sell.

For a further discussion of this (including protecting all of the properties in the one entity, see Chapter 6.

Reference Source (return tab): SAP 23, Part F
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. REASONS WHY INVESTORS ARE TAGGED AS DEALERS

Many “investors” are inappropriately tagged as “dealers”, not necessarily at first by the IRS but more commonly from the following internal sources:

1. From their CPA’s, carelessly and incompetently classifying investors as dealers.

*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
2. From improper wording in documentation (such as a partnership or LLC operating agreement) indicating a primary intent to sell as opposed to rental investment intent as discussed in Chapters 6 and 42.

3. From using a separate entity solely for resale flippers demonstrating a dealer sales intent instead of investor investment intent as discussed in Chapter 6.

B. STRATEGIES TO UNDO COSTLY DEALER STATUS PROSPECTIVELY IN THE FUTURE

1. Immediately stop using any present “dealer” entity for any future property purchases. Most often such a dealer entity is a corporation with all of its drawbacks as discussed in Chapter 5A. But regardless of the type of entity (S-corp, C-corp, LLC or LP), stop using this entity (along with its dealer “taint”) for any more property acquisitions.

Once the entity sells or otherwise disposes of all the properties, dissolve the entity, along with the dealer “taint”.

2. New LLC. For new property purchases form a brand new pristine LLC-partnership as your investment entity using the consolidated entity approach as discussed in Chapter 6.

3. Investment intent. Incorporate a notarized version of The Statement Of Investment Intent as part of the LLC operating agreement and minutes. The Statement Of Investment Intent is contained in Chapter 42 and Appendix E.
4. **Follow the dealer avoidance strategies** discussed in Goldmine Chapters 6 and 42.

5. **Immediately fire, or avoid any so-called tax advisors who do not go along with the Goldmine dealer avoidance strategies** (or any other Goldmine strategies for that matter). Refer to our special report, “80-15-5” -- *How To Determine The Competence Or Incompetence Of A Tax Advisor, Including Your Own*. (Includes how to fire your own CPA).

### C. STRATEGIES TO FILE PRIOR YEARS’ AMENDED RETURNS FOR REFUNDS OF PAST PAID TAXES

Consider filing an amended return to undo prior dealer status and regain investor status. But do this only if there is the following:

1. It will enable you to recover refunds of past paid taxes, such as Social Security taxes incorrectly paid on non-business *investor* gains and/or higher ordinary income taxes incorrectly paid on long-term capital gains from *investor* sales;

2. If you have sufficient documentation to support investor status. Such documentations should include the following:
   
   (a) *The Statement Of Investment Intent*, signed and notarized (preferably with a notary date before the time of the sales transactions).

   (b) An LLC operating agreement along with resolutions indicating investment intent to hold and lease properties (preferably with dates before the time of the sales transactions).
(c) A business plan indicating investment intent and purpose (preferably with a plan date before the time of the sales transactions).

(d) Other documentation such as third party correspondence, management contracts or purchase agreements indicating investment intent; promotional materials renting or attempting to rent (not sell) the property such as flyers, newspaper ads, rental listing agreements, internet (preferably with dates before the time of the sales transactions).

For the filing of amended returns, with your Renaissance VIP code email us we can recommend a competent tax specialist to assist you with your amended return.

Reference Source (return tab): SAP 37

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
How To Treat Losses On The Sale Or Disposition of Real Estate With Planning Strategies

In this chapter we cover the following:

I. ENTREPRENEURS ALWAYS PLAN IN ADVANCE!

II. ACCURATELY COMPUTE THE LOSS ON THE DISPOSITION

III. THE TAX TREATMENT OF A REALIZED LOSS

I. ENTREPRENEURS ALWAYS PLAN IN ADVANCE!

Many (including some tax advisors) have the misconception that if someone has a loss, then there is no need to do advanced tax reduction planning. How wrong they are!

While losses on the sale of real estate are not nearly frequent as gains, they do occur (especially in slow markets). If there will be a loss on the sale, you want to use different tax planning techniques than those for a gain. For example, a 1031 exchange, and other planning techniques to reduce gain, would not be appropriate and therefore not recommended.
The computation for a \textit{realized loss} on the sale of a property is the same as that for a gain, except that the adjusted basis of the property exceeds the net selling price and not vice versa. (Chapter 29 covers the computation of realized gain).

\section*{II. ACCURATELY COMPUTE THE LOSS ON THE DISPOSITION}

\textbf{Basic Format For Computing Realized Loss}

1. Total Selling Price..........................\$\text{__________}
2. Less: Selling Expenses.................................- \text{__________}
3. Equals: Net Selling Price..........................\$\text{__________}
4. Less: Adjusted Basis.................................- \text{__________}
5. Equals: Loss (Line 4 exceeds line 3)..................\$\text{(__________)}

\textbf{NOTE:} If there is a gain (line 3 exceeds line 4), skip this chapter go to Ch 29.

\section*{III. THE TAX TREATMENT OF A REALIZED LOSS}

The tax treatment of a realized loss on the sale or disposition of property will either be one of the following listed below and then further discussed:
A. CAPITAL LOSS, DEDUCTIBLE, GENERALLY SUBJECT TO LIMITATIONS

B. ORDINARY LOSS, FULLY DEDUCTIBLE, NOT SUBJECT TO LIMITATIONS

C. NON-DEDUCTIBLE PERSONAL LOSS

D. NON-DEDUCTIBLE OR POSSIBLY DEDUCTIBLE LOSS WITH A RELATED PARTY

A. CAPITAL LOSS, DEDUCTIBLE, GENERALLY SUBJECT TO LIMITATIONS

1. Tax treatment - A net capital loss (such as from the sale of a stock) is deductible against ordinary income only in the amount of the lower of $3,000 or your total taxable income for the year. IRC 1211, Reg. 1.1211-1. For individuals, an unused capital loss in excess of the $3,000 (or lower taxable income) is carried forward indefinitely, IRC 1212. But capital losses can fully offset both short and long-term capital gains, IRC 1211. You must first net your capital gains and losses. The net gain is capital, and any net loss is also capital. IRC 1222.

2. Capital assets - Assets that incur capital losses are capital assets, such as raw land, stocks and bonds, IRC 1221. Rental real estate, business-use real estate and depreciable personal property are not capital assets, even though all or part of their realized gain may be a capital gain (as discussed in Chapter 29). Instead, they are considered “Section 1231” assets, which receive special treatment in that all or part of their realized gain may be capital, yet a realized
loss is a fully deductible ordinary loss, IRC 1231. (Section 1231 assets are further discussed in this chapter, part B.)

**EXAMPLE 1:** In the same tax year, you sell land at a capital gain of $10,000 and a stock for a loss of $30,000. Assume that you have no other capital gain or loss transactions and that your taxable income is in excess of $3,000. Your net capital loss is $20,000 ($30,000 gain, less the 10,000 loss) Of the $20,000 net capital loss, $3,000 can be used to offset ordinary income. The remaining $17,000 can be carried forward indefinitely, and in subsequent years can be deducted in the amount of $3,000 per year; or more of there is a capital gain in a subsequent year.

**EXAMPLE 2:** Same facts as above, except in the following year, you sell real estate that has a capital gain of $17,000. The above $17,000 capital loss carryforward can fully offset the $17,000 capital gain, leaving a (nice) zero net taxable gain.

3. **Strategy: Accelerate Capital Gains to Fully Use Capital Losses** -- The loss can then be used to offset the gain, which would no longer be taxable.

**EXAMPLE 3:** You have a stock loss of $20,000. Because a loss on the sale of stock is considered a *capital* loss, it is limited to only $3,000 a year as a deduction against ordinary income. (The remaining unused loss can be carried forward indefinitely.) However, assume you have another winner stock that has gone up in value by $20,000. Because the $20,000 increase in value is a *capital* gain if it is sold, it can be fully offset by the $20,000 capital loss on the other stock. With the full offset, you have no taxable income, yet you now have $20,000 *tax-free* cash in your pocket. The same can be done for a capital gain from the sale of real estate.

**TIP 1:** You can buy back the winner stock in 31 days without interfering with the above tax strategy.
TIP 1: Also check your state and local laws for offsetting gains and losses.

B. ORDINARY LOSS, FULLY DEDUCTIBLE, NOT SUBJECT TO LIMITATIONS

1. Tax treatment - A net ordinary loss (such as from the sale of rental real estate) is deductible in full without limit, IRC 1231. An ordinary loss can fully offset your other income (both capital and ordinary). It could also qualify as a business loss for computing a potential net operating loss (NOL). See Chapter 28 for a further discussion of NOL’s.

2. Assets eligible for a fully deductible ordinary loss –
   (1) Rental/business-use property and
   (2) Dealer property. These are further discussed as follows.

   (1) Rental/business-use property. The first category includes: Rental real estate, business-use real estate, depreciable personal property connected with real estate and other business-use personal property such as a business auto or machinery. Regardless of the time held (holding period), the losses on these type of assets are preferential ordinary loss. However, if these assets are held long-term (more than one year), the losses are still ordinary, yet any gains (except for depreciation recapture) are preferential long-term capital gain. These “best-of-both-world” assets are known as “Section 1231” assets. The long-term capital gain is called a 1231 gain* and the fully deductible ordinary loss is called a 1231 loss. (*Ordinary income from depreciation recapture is taxed separately and is not part of a 1231 capital gain).
If you have several dispositions of Section 1231 assets in one tax year, you must net the 1231 gains and 1231 losses. If the netting results in a gain, you report it as a long-term capital gain (from which you can fully offset capital losses, such as from the sale of stocks, bonds and land). On the other hand, if the netting results is a loss, you fully deduct it as an ordinary loss, which could also qualify as a net operating loss (NOL).

**EXAMPLE 4:** You sell a rental property for a loss of $20,000. This loss is a fully deductible Section 1231 ordinary loss, which can offset your income in full. It could also qualify as a business loss for computing a potential NOL.

**EXAMPLE 5:** In the same tax year, you sell rental property at a capital gain of $12,000 and a business auto for a loss of $22,000. The 1231 capital gain of $12,000, less the 1231 ordinary loss of $22,000 equals a net 1231 loss of $10,000, which is a fully deductible ordinary loss. Again, It could also qualify as a business loss for computing a potential NOL.

**3. Alert: On Exception Where a Section 1231 Gain Is Not A Capital Gain** ("Nonrecaptured Section 1231 Losses"): This occurs where you have previously deducted Section 1231 losses in the prior five (5) years. Here, 1231 gains are taxed as ordinary income to the extent of 1231 losses deducted during the immediate preceding five years, IRC 1231(c). In other words, you are recapturing your prior 1231 losses as ordinary income under these rules.

**EXAMPLE 6:** Same facts as the previous example, where you deducted $10,000 as a 1231 loss. Assume in the following year you sell a rental property at a 1231 gain of $25,000. Of the $25,000, $10,000 is fully taxable ordinary income recapturing the previous 1231 loss of $10,000. The remaining $15,000 is a long-term capital gain.

**3A. Strategies for Above Non-Recaptured Section 1231 Losses:**
1. Wait until the 5-year-Section 1231 loss-period expires.

2. Even better, employ a 1031 exchange or other strategies to defer or eliminate any 1231 gains. *Reason:* No taxable gain equals no 1231 loss recapture.

(2) **Dealer property.** A second category of assets entitled to ordinary loss treatment is property held primarily for sale to customers in the ordinary course of business (“dealer property”), IRC 1221. The loss on the disposition of these assets is ordinary, but so is the gain!

Thus, they do not receive the preferential tax treatment of Section 1231 assets. There are other numerous tax disadvantages of dealer property. For a further discussion of investor-vs-dealer, including dealer avoidance strategies, see Chapters 41 to 43A.

C. NON-DEDUCTIBLE PERSONAL LOSS

1. **Tax treatment** - This type of loss is not deductible at all and provides no tax benefit whatsoever. Reg. 1.262-1(b)(4); Reg. 1.165-9(a).

2. **Assets subject to personal losses** - Personal-use assets - a primary residence, a second home, a personal car, personal jewelry, etc.

EXAMPLE 7: You sell your personal residence for a selling price of $140,000, selling expenses of $10,000 and an adjusted cost basis of $180,000. You have a loss of $50,000. ($140,000 - 10,000 - 180,000). In a rounded 30% bracket a
business loss of $50,000 would equate to $15,000 in tax savings. However, because this a personal loss it is not deductible at all. Result: NO tax savings at all.

3. Strategies to Deduct Losses on Personal-Use Real Property

Strategy 1: Don’t sell while the property is a personal-use asset; convert it to a rental; actually rent the property for a reasonable amount of time, with an written arm’s length lease at market rent preferably to an unrelated party (defined in part D of this chapter). To secure the loss deduction on the ultimate sale, it is not enough if the property is just held out for rental. It must actually be rented. A lease must be executed, Cullman, (1919) 16 BTA 991(A). An oral lease with a prospective tenant is not enough, Grohse, TC Memo 1968-47. Nor is a temporary tenancy by the ultimate purchaser. Such a tenancy is merely incidental to the sale of the property, Dawson, Jr., TC Memo 1968-47. But where the property was rented without a lease on a month to month basis, a loss was nevertheless allowed, Sweet v. US, 7/9/68, DC-Calif. Thus, to deduct the loss on the sale* of the property, it must be actually rented for a reasonable amount of the time. An educated guess would be at least six months to one year.

* NOTE: On the other hand, to deduct rental-operating losses, the property does not have to be actually rented, but held out for rental with intent for profit. See Chapters 15 & 28 for a further discussion.

ALERT: On the lower market-value basis that must be used for deducting the loss. When a personal-use property is converted into a business or investment property, the basis at the time of the conversion is the lower of the property’s present adjusted cost basis or the property’s fair market value, Reg. 1.165-9(b)(2); 1.167(g)-1. (Emphasis added) Therefore, if the fair market value is less than the adjusted cost basis, then you must use the lower market value,
which means a lower basis and a smaller loss. The problem is that in a loss situation, the adjusted basis is always higher than the market value. This is what causes the loss in the first place. Again, in this scenario, you must use the lower market value.

**EXAMPLE 8:** In the previous example, you sold your personal residence for a non-deductible loss of $50,000. However, assume that you do not sell and convert the home to a rental property by actually renting it for a year. For the year you claim depreciation of $6,000. After the one year rental, you sell the property for a net selling price of $130,000. Assume that at the time of the conversion the property’s adjusted cost basis was $180,000 and that you, along with your accountant, estimate that the fair market value is $140,000. For both the purposes of computing depreciation and the loss on the sale, you must use the lower fair market value as the property’s basis. The amount here is $140,000, not $180,000. Therefore the adjusted basis for computing the loss is $134,000 ($140,000 less $6,000 depreciation). The deductible loss on the sale is only $4,000 ($130,000 selling price less the $134,000 basis). In a rounded 30% tax bracket, a 4,000 deductible ordinary loss yields only $1,200 in tax savings

**Strategy 2:** Obtain an opinion of a higher market value at the time of the conversion. A higher market value means a higher basis which in turn means a larger loss deduction.

**EXAMPLE 9:** Same facts as the previous example, except that you obtain an opinion from a professional appraiser that the fair market value at the time of the conversion is $160,000. For purposes of simplicity assume the same $6,000 for depreciation. Now the basis for computing the loss is $154,000 ($160,000 - 6,000). The deductible loss on the sale is now $24,000 ($130,000 selling price less the $154,000 basis). In a rounded 30% tax bracket, a 24,000 deductible ordinary loss yields a much better $7,200 in tax savings
NOTE: “Market Value” vs. “Selling Price” - Both tax advisors and IRS agents will often contend that if a property sold for a certain selling price, then the actual selling price should be the market value. Based on this premises, the value of this property (and the basis) would be $130,000 (the actual selling price) and not $160,000 (the appraised value). But we, in real estate, know that “market value” and “selling price” are often not the same thing. They can differ for several reasons such as the motivations of the seller or buyer, the market knowledge of the seller or buyer, the terms of the sale, the time on the market and differences with comparable properties. A further explanation of market value is discussed later in this chapter.

4. Tax Break for Inherited Property Losses - Loss on the sale of a personal residence may be allowed for inherited property even if the property is not actually rented - There are cases where taxpayers were allowed loss deductions on the sale of a personal residence, without actually renting the property, where the property was inherited by the taxpayer. Losses were allowed in the following cases:

- Loss on the sale of inherited property which was the residence of the deceased can be deductible if the taxpayer immediately attempts to rent or sell the property, Campbell, (1954) 5TC 272.

- If the taxpayer was living in the house at the decedent’s death, a loss will be allowed if he indicated his intention to move and does so as soon as he can locate other quarters - a reasonable time being allowed to do this, Crawford, (1951) 16 TC 678 (a).

- The same rule applies where the house is owned and used as a residence jointly by the husband and wife or by the decedent alone, and one of them dies; the other can deduct the loss on the sale of the house, if he or she stops using it as a residence reasonably soon after the spouse’s death, Est Miller, TC Memo 1967-44; Watkins, TC Memo 1973-167.
• Likewise, the fact that the taxpayer lived in the house (such as a beneficiary of a trust during minority) doesn’t necessarily bar a loss on the sale, Carnrick, (1947) 9TC 756 A.

• Actual rental before sale isn’t necessary, unless the property was, in fact, used as a taxpayer’s residence after inheritance, Carnrick, ibid.

But, once inherited property is used as a residence after inheritance, it must actually be rented out prior to sale in order for the taxpayer to be allowed to deduct the loss.

NOTE: The loss on the above types of unrented inherited property is a capital loss, limited to $3,000 a year against ordinary income. But if the property is actually rented and then sold, the loss should be a fully deductible ordinary loss.

4A. Strategies for Personal-Use Inherited Properties: Based on the aforementioned cases, for personal-use property that is inherited, do the following:

1. Move out of the home as soon as possible (if you are occupying it).

2. Make definite and clearly documented attempts to sell the property.

3. Hold the property out for rent (but if you are trying to sell, this may not be necessary).

Doing the above should entitle you to a capital loss deduction. However, if you want to incur a fully deductible ordinary loss, actually rent the property before selling in order to incur an ordinary loss.
**NOTE – Basis of inherited property is market value:** As previously discussed, when a personal-use property is converted to a business or investment property, the basis at the time of the conversion is the lower of the property’s present adjusted cost basis or the property’s fair market value. When the property is inherited the basis is the market value at the date of death (or alternate valuation date). There is a "step-up" of the tax basis to the fair market value, IRC 1014. Also, with inherited property you do not have the above rule, where you must use the lower of the adjusted cost basis or fair market value. Here, you just use the fair market value as per IRC 1014. Thus, the latter (basis as market value) presents an interesting tax-reduction scenario in the event that an inherited personal-use property is sold at less than the market value basis.

**EXAMPLE 10:** JJ inherits his aunt’s house which is appraised at $100,000, which is the valuation used for estate purposes. Thus, the tax basis for JJ is $100,000. Assume the property is free & clear of debt. JJ is an out-of-state owner and knows nothing about managing or owning real estate. Accordingly, he just wants to cash out quickly. He knows that he can do this by selling the property for a lower price. JJ also knows that whatever net cash he receives is pure cash profit. AA, a savvy investor, makes an “all-cash”, “as-is” quick offer on the property for $75,000. The highly motivated and anxious JJ accepts the offer for $75,000; pays another $5,000 in selling expenses and thus has a $30,000 loss on the property ($75,000 less selling expenses of $5,000, less the adjusted basis of $100,000).

*Question:* Is the $30,000 loss on the sale of this property deductible?

*Answer:* Yes, based on the above cases and provided JJ follows the above planning strategies. Again, the type of loss on the above types of unrented inherited property is a capital loss, limited to $3,000 a year against ordinary income.
Strategy 1 for JJ - Accelerate Capital Gains: Assume JJ has a “winner” stock, which he sells for a $30,000 gain. Because the $30,000 is a capital gain, it can be fully offset by the $30,000 capital loss on the sale of the unrented inherited property. With the full offset, JJ has no taxable income, yet now has $30,000 tax-free cash in his pocket! (JJ can buy back the winner stock in 31 days without interfering with the above strategy).

Strategy 2 for JJ - Rent the Property For an Ordinary Loss: If JJ actually rents the property for a period prior to the sale, the loss should be a fully deductible ordinary loss. (And deduct rental property tax losses while renting the property).

NOTE: “Market Value” vs. “Selling Price” - Again, both tax advisors and IRS agents will often contend that if the property sold for a certain amount of selling price, then the actual selling price should be the market value. Based on this premises, the value of JJ’s property (and basis) would be $75,000 (the actual selling price) and not $100,000 (the appraised value). Thus, there would be no “loss”! But “market value” and “selling price” are not the same thing. Why? because of the appraisal definition of “market value”-- The most probable price of which a property should bring in a competitive and open market under all conditions requisite to a fair sale and the buyer and seller, each acting prudently, knowledgeably and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from the seller to the buyer under conditions whereby: (1) The buyer and seller are typically motivated; (2) Both parties are well informed and well advised, and each acting in what they consider his or her own best interest; (3) A reasonable time is allowed for exposure in the open market; (4) The price represents the normal consideration for the property sold unaffected by special sales concessions* or creative financing* (*Adjustments to comparable properties must be made for special sales concessions or creative financing). (underlined emphasis added).
The Final Analysis: JJ’s actual selling price is not market value, mainly because of the underlined items in the above definition. He therefore is entitled to the above deductible loss.

D. NON-DEDUCTIBLE OR POSSIBLY DEDUCTIBLE LOSS WITH A RELATED PARTY.

1. Initially Not Deductible - If a property is sold or exchanged to a related party (defined below), you cannot deduct a loss, even if the loss is otherwise deductible, IRC 267(1).

2. May Later Be Deductible - If the original related party later sells the property to an unrelated party, then the previously disallowed loss is deductible, but only up to the extent of any gain on the second transaction, 267(d). Any amount of the loss that is lower than any gain is not deductible at all and wasted, Reg. 1.267(d)-1; IRS Pub. 544.

EXAMPLE 11: You sell to your brother (a related party) an investment property at a loss of $2,500. Because this is a related party transaction, the $2,500 loss is not currently deductible. Your brother later sells the property to an unrelated party at a gain of $4,000. The previously disallowed loss of $2,500 offsets the gain of $4,000, resulting in a recognized gain of $1,500. Here the loss becomes fully utilized and provides a tax benefit by reducing the taxable gain.

EXAMPLE 12: Same facts as above, except your brother sells the property for a gain of $1,000. The previously disallowed loss of $2,500 offsets the gain only up to its total amount of $1,000. Consequently, there is no recognized gain.
However, the remaining loss of $1,500 is not deductible at all and its tax benefit is lost forever (down the drain!)

A. The following are “related parties” for the above rule: *Under IRC 267(b) and 267(c)(4) “related parties” include spouses, parents, grandparents, children, grandchildren, brothers, sisters and more than 50% owned entities such as LLC’s, corporations, partnerships, trusts, etc.

B. However, the following are not “related parties” for the above rule: Aunts, uncles, cousins, nieces, nephews, X-spouses, business associates, close friends, a 50% or lower ownership in one of the above entities, and probably not in-laws.

3. Planning Strategies to Get Loss Deductions or Some Benefit:

1. Sell to an unrelated, but “friendly” party, such as those listed in paragraph B above.

2. Sell to a related party, but make sure that there will be enough gain on the second unrelated party transaction to fully utilize the disallowed loss.

3. Sell to a related party, but connect the sale with a buy-back option or some other similar type arrangement that would allow you to reap future benefits from the property.

**TIP:** Such transactions should be structured with arm’s length documentation to counter any IRS attacks on “sham” transactions.
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A form of disposition that can result in a deductible loss is “abandonment” where you totally abandon a property. If it is depreciable property, you deduct the property’s remaining adjusted basis as a fully deductible ordinary loss. According to Reg. 1.167(a)-8, when an asset is permanently retired or scrapped from use in a trade or business, then there is a loss deduction in the amount of the remaining adjusted basis in excess of the estimated salvage value (if any) or the fair market value at the time of the retirement.

If the asset is non-depreciable property (such as land), then an abandonment loss is allowed, provided that there was intent to make a profit and that the transaction arose from a sudden termination of the usefulness of the property or where such property is permanently discarded from use, Reg. 1.165-2(a). The loss is deductible in the year sustained under IRC 165(a). For this purpose, the tax year in which the loss is sustained is not necessarily the tax year of the overt act of abandonment, or the loss of property title, Reg. 1.165-2(a). There must be a completed transaction or an identifiable event

**TIP:** Document that the abandonment has occurred, ideally from third party documentation such as from an attorney, Realtor or title company.

An abandonment loss also applies to leasehold improvements the lessor made for the lessee that were abandoned, IRS Pub 544. The same rule appears to
apply to the lessee, if the lessee made improvements and then later moved from the leased premises. The remaining basis of the leasehold improvements is then deductible as an ordinary loss.

**TIP 1:** The abandonment loss is an ordinary loss, even if the property is a capital asset, such as land, Reg. 1.165-2(b), IRS Pub. 544. (But see the alert 1 below.)

**TIP 2:** The abandonment is a fully taxable disposition that will trigger the use of suspended passive losses. See Chapter 25-A for a further discussion.

**ALERT 1:** If the abandoned property is foreclosed on, the gain may be a capital gain even for depreciable property. Also, in the event of a foreclosure, you may incur a taxable gain, IRS Pub. 544. For a further discussion see *The 1031 Money Machine*, Section VIII-18

**ALERT 2:** You cannot deduct an abandonment loss for a personal-use property, such as a primary or second home, Reg. 1.262-1(b)(4); Reg. 1.165-9(a). However, see the planning strategies in the previous chapter on deducting losses on personal-use real property (such as a residence).

You claim deductible abandonment losses on IRS Form 4797, Page 1, Part II. See IRS Pub 544 for further reference.

**UPDATE:** The loss on an abandoned investment is deducted as an ordinary loss, the Tax Court says in a case where a couple gave up the $25,000 they paid for a franchise. The franchisor had flooded their area with stores, and many of them were losing money. When the franchisor refused to return the $25,000, they figured they were better off walking away from the deal than investing more of their funds in a venture that was likely to be in the red (Alami El Moujahid, TC Memo. 2009-42).

Reference Source (return tab): SAP 32
ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
APPENDIX A: Componentizing - Personal Property Vs. Real Property - Legislative History, Further Tax Law Support, More Planning Strategies

GENERAL CONTENTS – APPENDIX A

The issue of personal vs. real property - legislative history

Three important guidelines that have been used in distinguishing between real and personal property are: 1. MOVEABILITY, 2. ACCESSORY TO THE OPERATION OF A BUSINESS and 3. FUNCTION AS EQUIPMENT

1. Moveability is the primary requisite in classifying an item as tangible personal property ("MOVEABILITY")

2. Assets accessory to the operation of a business, generally constitute personal property, even though such assets may be fixtures under local law ("ACCESSORIAL" CONCEPT)

3. if it functions as machinery or equipment, a structural component can be personal property even if permanently attached, ("FUNCTION” TEST)

Components (such as electrical and plumbing) that support personal property items, should also be personal property, even if they are generally real property (Scott Paper Co. Case)

Discussion of some other controversial components

Concluding points

Planning to Increase Personal Property Deductions
THE ISSUE OF PERSONAL VS. REAL PROPERTY - LEGISLATIVE HISTORY

The issue of personal vs. real property goes back to the 1960’s when we had the Investment Tax Credit (“ITC”) for personal property used in a trade or business, such as machinery, equipment and office furniture (also referred to as “Section 38” property and “Section 1245” property). If you purchased such personal property you would be entitled to a tax credit (ITC) of 10% of the cost of the property. For example, a $30,000 purchase would result in a $3,000 credit directly against your tax liability. In effect, you paid $27,000 for the assets.

The ITC was obviously valuable and taxpayers started to become creative & aggressive in reclassifying what appeared to be non-qualifying real property into qualifying personal property. This creative approach begins with Regulation 1.48-1(c) which states “Local law shall not be controlling for purposes of determining whether property is or is not personal. Property may be personal property even if under local law the property is considered a fixture and therefore real property”. This is further supported by a 1962 Senate report: “Tangible personal property is not intended to be defined narrowly here, not to necessarily follow rules of state law. Sen. Rep. 1881, 87th Cong, 2d sess, 1962.

Thus, the tax law is more liberal than state or local real estate law in classifying a property item as personal, as opposed to real. The result of all this has led to a multitude of cases and rulings on this issue, many of which have been in the favor of the taxpayer. The ITC was repealed in January, 1986. Consequently, many forgot about this still important issue. The distinction between personal and real property is still the significant difference of writing an asset over 5 years versus of 27-1/2 or 39 years, IRC 168(c). Moreover, with Section 179/first year expensing, certain personal property may qualify for a large write-off all in one year. (See Section 13 for a further discussion of first-year expensing.) Accordingly, we will vigorously pursue this area of the tax law with the following discussion.
THREE IMPORTANT GUIDELINES THAT HAVE BEEN USED IN DISTINGUISHING BETWEEN REAL AND PERSONAL PROPERTY ARE:

1. MOVEABILITY, 2. ACCESSORY TO THE OPERATION OF A BUSINESS and 3. FUNCTION AS EQUIPMENT.

1. MOVEABILITY IS THE PRIMARY REQUISITE IN CLASSIFYING AN ITEM AS TANGIBLE PERSONAL PROPERTY - This is consistent with RR 65-79 (the IRS’s first ruling on this issue) which states that if property is movable and its removal will not impair the function of the building as a building, the property is tangible personal property. This is further supported by the principal case in applying the test of moveability, Whiteco Industries, Inc., 65 T.C. 664 (1975), acq. Faced with the question of whether outdoor advertising signs constituted personal property (which they are), the Court asked the following 6 questions (with my suggested answers in brackets):

(1) Is the property capable of being moved, and has it in fact been moved? (“Yes” is better)

(2) Is the property designated or constructed to remain permanently in place? (“No” is better)

(3) Are there circumstances which show that the property may or will have to be moved? (“Yes” is better)

(4) How substantial a job is removal of the property and how time consuming is it? (“Not much”)

(5) How much damage will the property sustain upon its removal? (“Not much” is better)

(6) What is the manner of affixation of the property to the land? (“Not too permanent”).

It should be pointed out that in no part of the Whiteco opinion, does the Court suggest that all six tests must be met in every case. These tests are overall guidelines to help provide judgment in this area. However, they should be taken
into consideration with the other criteria discussed in this section. Examples of applying moveability are:

ELECTRICAL COMPONENTS - The “Whiteco tests” were also applied in another landmark case, *Scott Paper Co.*, 74 TC 137 (1980). Here it was demonstrated that electrical components were “readily removable”. This case also resulted in other favorable findings, discussed later in this appendix.

BANK WINDOWS - In Revenue Ruling 65-79, the IRS considered walk-up and drive-up bank teller windows to be tangible personal property, because the windows could be removed without affecting the structure’s operation as a building. (Emphasis added)

MOVABLE WALL PARTITIONS - These are personal property because they are easily movable. Here, we have many cites - RR 75-178; Sen. Rep. 92-437; *King Radio Corp, Inc.* 73-2 USTC 9766 (CA-10); *Minot Federal Savings & Loan Assn.*, 71-1 USTC 9131 (CA-8); PLR 7907159. Also, according to tax expert, Ron Noll, CPA (1-800-360-6655), the same would apply to non-weight bearing walls, which are interior walls that do not have any weight at all on them. Nothing is set on the wall. You can easily move the wall. They are movable.

**EXAMPLE**: $80,000 is expended for interior walls. $80,000 over a rounded 40 (39) years = $2,000 a year deduction, vs. $80,000 over 5 years = $16,000 a year deduction. **A deduction difference of $14,000 a year! Under Section 179, first year expensing, you can write off up to $24,000 all in one year!** (See Section 13)

**TAX TIP**: For new construction or major renovations, install non-weight bearing walls for interior walls and get a 5-year write-off. Ron Noll has done this for his own office and has recommended it to his clients. He has held up with it on IRS audits as he should. Moreover, retaining walls qualified as personal property under PLR 7102269400A.

MOBILE HOMES (TRAILERS) - The IRS argued that these were “buildings”. Even though they appear to be buildings and even function as buildings, the tax court disagreed by stating that the trailers could not be buildings because they were never affixed to the land and remained at all times movable, *Joseph Moore*, 58TC 1045 (1972). Note: It also helps that state law generally considers trailers that are not permanently affixed, to be personal property.
“FOTOMATS” - These tests, emphasizing the criterion of moveability, were also used in *Film N’ Photos, Inc.*, T.C. Memo 197-162. Even though they looked like buildings and even functioned as buildings, photographic-service merchandising huts (“Fotomats”), located on shopping center parking lots, were considered to be personal property. The deciding factor was that the merchandising huts were not permanently affixed; the entire units could be moved readily to a different location. (Emphasis added)

**STRATEGY:** Entrepreneurs often have a choice in determining whether an asset will be real or personal, via moveability. For example, a guard station built into a building lobby is 39 year real property, whereas a guard station that is set up in the lobby (and can be removed) is 5-year personal property (like the Fotomat merchandising huts). The same distinction can apply to permanent walls vs. movable walls and partitions, central air vs. portable air-conditioning units, installed lighting vs. movable lighting, etc. [The above tip thanks to Jerry Monarch, of Marshall & Stevens, Appraisers, (813) 962-7888 Ext. 104]

2. **ASSETS ACCESSORY TO THE OPERATION OF A BUSINESS, GENERALLY CONSTITUTE PERSONAL PROPERTY, EVEN THOUGH SUCH ASSETS MAY BE FIXTURES UNDER LOCAL LAW (“ACCESSORIAL” CONCEPT) –**

The “accessorial” concept is basically from the language of the Technical Explanation (858), i.e., “assets accessory to the operation of a business, such as machinery, printing presses, transportation or office equipment, refrigerators, individual air-conditioning units, grocery counters, etc. These assets generally constitute tangible personal property, even though such assets may be termed fixtures under local law”. In contrast the Regulations simply state, “Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks & shelves, and neon and other signs, which is contained in or attached to a building constitute tangible personal property”, Regulation 1.48-1(c). The same reasoning was used in Revenue Ruling 69-170, when it considered seats in a baseball stadium (which is a building) to be tangible personal property, because the seats were “neither essential parts of the building, nor are they items that relate to the operation or
maintenance of the building”. Instead they related to the *operation of the taxpayer’s business*. (Emphasis added)

**COMMENT:** There are certain property components that would be in a building regardless of the type of business and thus such property should be classified as structural components, and accordingly, non-qualifying. However, there are those assets that are in a building *only* because they are related (i.e., **“accessorial”**) to a particular *business*. That is, if the particular business did not exist, then the related or accessorial assets would also not exist. For example, the business of a retail store may contain certain assets such as counters, racks, shelves, signs, display cases, etc. While these assets may be considered real property fixtures under local law, for tax purposes they are tangible personal property, because under the **“accessorial concept”**, they are directly related to the operation of this business. If you take away the business of the retail store, then there would be no need for the above mentioned assets. In Revenue Ruling 65-79, the IRS considered walk-up and drive-up teller windows to be tangible personal property, because the they were accessorial to the taxpayer’s business of banking.

### 3. IF IT **FUNCTIONS** AS MACHINERY OR EQUIPMENT, A STRUCTURAL COMPONENT CAN BE PERSONAL PROPERTY EVEN IF PERMANENTLY ATTACHED, (**“FUNCTION”** TEST) - This very much relates to the above accessorial concept. Examples are:

GREENHOUSE - Even though a greenhouse appeared to be a building, it was personal property because it **functioned like machinery** in that it provided a controlled environment for growing flowers and employee activity was only incidental to that function. The court of appeals rejected the IRS’ **“appearance”** test that the greenhouse looked like a building, *Arnie Thirup*, TC 122 (‘72), rev’d 508. F.2d 915 (CA ‘75). Note: It also helped that a **“building”** permit was not required for the greenhouse. (Emphasis added)

STORAGE FACILITIES - Will qualify as personal property provided that it is solely for storage and does not contain any space for workers, *Hart*, TC Memo 1999-236. Here, the storage facility **functions as equipment**. On the other hand, truck-docking facilities were buildings because of the substantial, essential daily human activity of the dock’s workers, *Consolidated Freightways, Inc.*, 74 TC
768 (1980), 620 F2d 862 (Ct. Cl. 1980). The same conclusion would apply to a
warehouse, which is real property. (Emphasis added)

BANK WINDOWS - In Revenue Ruling 65-79, the IRS considered walk-up and
drive-up teller windows to be tangible personal property, because they must be
“equipment” (personal property), instead of real property “structural
components”.

TOWERS - Ski lift support towers and the associated machinery were in the
nature of machinery (personal property), regardless of their permanency, Joseph
B. Weirick, 62 TC 446 (1974). A similar conclusion was reached for steel towers
that were part of a ride in an amusement park, Marineland of the Pacific, Inc. 34
TCM 1250 (1975).

OTHER - Gasoline pumps, hydraulic car lifts, and automatic vending machines,
although annexed to the ground, are considered tangible to be personal property,
Regulation 1.48-1(c)]. Also, gasoline storage tanks qualify, RR 74-602. They all
function as machinery.

APPLYING THE ABOVE CONCEPTS TO KITCHEN FIXTURES
(CABINETS, SHELVES, COUNTERS, ETC.) IN A RESIDENTIAL RENTAL
PROPERTY SUCH AS AN APARTMENT BUILDING OR RENTAL HOUSE
- Such kitchen fixtures, which are generally considered fixtures under local law,
should qualify as tangible personal property. This type of property should fit
under the accessorial concept, because without the business of renting apartments
or houses, there would be no need for these assets. Perhaps the IRS could argue
against this theory because such assets can be used for personal living purposes.
A counter-argument to this is this -- assets accessory to the operation of a
business such as office equipment, refrigerators, air-conditioning units, grocery
counters, etc. (previously mentioned) could also be used for personal purposes.
This does not necessarily mean that they should not come within the accessorial
concept and therefore not qualify as personal property.

Looking at it another way, apartment fixtures such as appliances, kitchen
cabinets, shelves, counters, etc. could also be used for other business purposes
such as in a restaurant, an office kitchen or cafeteria. Moreover, kitchen fixtures
are easily removable and function as machinery or equipment. Furthermore,
kitchen fixtures are not listed under Reg. 1.48-1(e)(2) as real property structural
components. Therefore, it is the author’s opinion, that they are intended to be 5-year personal property under Reg. 1.48-1(c).

APPLIANCES: Under Reg. 1.48-1(c), the same would hold true for appliances.

ON THE OTHER HAND, BATHROOM FIXTURES ARE REAL PROPERTY - Regulation 1.48-1(e)(2) specifically lists these as real property ("structural components"), probably because they would most likely flunk the important criterion of moveability. They are much more permanently affixed than kitchen fixtures and less accessorional.

COMPONENTS (SUCH AS ELECTRICAL AND PLUMBING) THAT SUPPORT PERSONAL PROPERTY ITEMS, SHOULD ALSO BE PERSONAL PROPERTY, EVEN IF THEY ARE GENERALLY REAL PROPERTY (Scott Paper Co. Case)

This stems from the Scott Paper Co. case (Ibid). Scott showed that the portion of an elaborate electrical system that furnished power to the machinery & equipment in the plant was personal property, logically because the machinery & equipment that it furnished power to was personal property. Scott had a component breakdown of the electrical system that pertained to the machinery & equipment as well as a component breakdown of the electrical system that pertained to the building (which was, logically, real property). Scott brought out something that was previously unheard of - even though normally real property, components (such as electrical and plumbing), that support personal property items, should also be personal property, not real property. (Emphasis added)

This is further supported by two more recent cases. Car washes were entitled to allocate the entire cost of electrical and plumbing systems, plus associated costs such as engineering, meters, connection fees, and installation as nonstructural personal property, Schrum, CA-4,97-1 USTC. Another case allowed as personal property a portion of the electrical system to service special machines, carpets and movable partitions, Health Corporation of America, 109, TC 21, 1997. The IRS now accepts this decision. IRS ILM 199921045. However, a hotel keycard door-lock system is real property, because doors are real property. The keycard system is an integrated element of the door. Illinois Cereal Mills, Inc. conducted a corn milling business in Illinois. In 1976, the company completed construction of a new milling facility in which 95 percent of the electrical load was used to run machinery in the mill, and the remaining 5 percent was used for lighting and
other general building needs. The Tax court found that 95 percent of the cost of the system qualified.

SUMMARY OF TAX LAW CITES SUPPORTING THE CLASSIFICATION OF PERSONAL PROPERTY UNDER THE THREE CRITERIA – MOVABILITY, ACCESSORY, FUNCTION

The classification of components as Personal Property - Regulation 1.48-1; Internal Revenue Code Sections 168(b), 168(e)(1), 1245(a)(3A); Regulation 1.1245-3(b); and any successor provisions issued thereunder, shall be done under one or more of the following three criteria:

(a) Movability in accordance with Senate Finance Committee report of the Revenue Act of 1978; Sen. Rep. 92-437; Reg. 1.48-1(c); Whiteco Industries, Inc., 65 TC 664 (1975), acq; Southland Corp. v. United States, 611 F.2d 348; Hospital Corp of Am. 109 T.C. 21; King Radio Corp, Inc. 73-2 USTC 9766 (CA-10); Minot Federal Savings & Loan Assn. 71-1 USTC 9131 (CA-8); Shoney’s S., Inc., T.C. Memo. 1984-413; Film N’ Photos, Inc., T.C. Memo 197-162, 1978; Revenue Ruling 65-79.

(b) Accessory (or Accessorial) in accordance with Technical Explanation (858) of Senate Report 1881, 87th Congress, 2nd Session 1962-3, CB 842, 858-59; Regulation 1.48-1(e)(2); Munford Inc., 87TC463; Shoney’s S., Inc., T.C. Memo 1984-413; The Senate Finance Committee on the Revenue Act of 1978; Revenue Ruling 69-170.

(c) Function in accordance with the sole justification rule essential to the operation of equipment per the Section 48 Regulations; Scott Paper Co.(74 TC 137, 1980); Illinois Cereal Mills Inc., CA 7, 86-1 TC 9371,789, F2d 1234; Arnie Thirup, TC 122 (‘72); Hart, TC Memo 1999-236; Joseph B. Weirick, 62 TC 446 (1974); Marineland of the Pacific, Inc. 34 TCM 1250 (1975); Schrum CA-4,97-1 USTC; Laurence A. Duaine, T.C. Memo. 1985-39; Piggly
DISCUSSION OF SOME OTHER CONTROVERSIAL COMPONENTS

DOORS: Most doors are necessary for the operation or maintenance of the building and therefore part of the building. However, the following doors have been held to be personal property: Roll-up doors and safety doors, (RR 70-103), vault doors (RR 65-079, PLR 640917577A). Moreover, under Scott, doors to movable wall partitions should also be considered personal property.

HEATERS: Regulation 1.48-1(e)(2) lists a “central air conditioning and heating system” as a real property structural component. However, in RR 67-099 a heater was considered tangible personal property and in RR 66-329 a heating system was considered tangible personal property, under the accessorial concept. Moreover, heaters function as machinery and are not that difficult to move. This one appears controversial.

In the depreciation case study (on disk as FMOPRSC), I did not allocated the heater as 5-year personal property. Reason: There is something in prudent tax planning known as the "pig theory" > Little Pigs Get Fed, Large Hogs Get Slaughtered. That is, don’t overdo it. Even though there are the above cites that say the heater could be personal property, by treating it as real property, you are showing that you have acted prudently. Afterall, I still allocated $15,900 toward personal property out of a total $100,000 cost. However, this does not say you can’t do it. If a new heater were later installed, I would treat it as personal property* (and fully write off the remaining basis of the old heater). *Reason: Modern-day heaters are light & moveable, like equipment, like “personal property”.

AUDIT TAX TIP: If you did not treat the heater as real property, keep this as a back-up defense in the event of an IRS audit. Here, you are showing that you acted prudently and, if necessary, ready to argue that the heater should be 5-year personal property as per the above.

HOT WATER HEATERS: The IRS could argue that these are permanent and function as part of the building. However, there is good support as personal property. Regulation 1.48-1(e)(2) does not specifically name hot water heaters
as real property. They are further supported as being personal by Private Letter Ruling (PLR) 7907159 and Rev. Rul. 81-199. Moreover, you could argue that hot water heaters function as machinery and are easily moveable.

LIGHT FIXTURES: This one can be controversial. If the light fixture is easily moveable it should be personal, RR 72-398; RR 72-223; Standard Oil 77 TC, No.28, 1981. Special lighting has qualified as personal property, S. REP. 95-1263, 1978-3 C.B. 315, 410-423.

SUSPENDED CEILINGS: The IRS could argue that these are permanent ceiling covers. However, you can counter with moveability. If carpeting can qualify, why shouldn’t suspended ceilings qualify? Moreover, we have support, Revenue Ruling 71-489.

CONCLUDING POINTS:

1. The above cases, rulings and concepts have established that certain items of property, long thought to be real, may be hidden personal property, eligible for much larger depreciation deductions.

2. A property may qualify as tangible personal property under more than one concept (movability, accessor, etc.) and each concept should be argued. For example, bank drive-up teller windows are supported by all three concepts: (1) Moveability, (2) Accessorial and (3) Functioning as machinery. The same for kitchen fixtures.

3. Componentizing is essential in identifying the qualified and non-qualified components in order to attain maximum depreciation deductions.

FINAL TAX TIP: When it doubt, call it personal property.

Planning to Increase Personal Property Deductions
Remember, under the tax law, there are three sets of criteria to determine if a property is 5-year personal property versus 27-1/2 or 39 year real property – Movability, Accessory and Function. These are briefly explained:

(1) Movability - If you can move the component without adversely affecting the building structure or the component is not essential to the function of the building, then most likely it’s personal property. Moveability is the primary requisite in classifying an item as 5-year personal property instead of 27-1/2 or 39 yr. real property.

(2) Accessory – If certain assets are directly related (accessory) to the operation of a business, they can be considered personal property even though they may be considered fixtures (real property) under local law.

(3) Function – If an asset “functions” as machinery or equipment, even a structural component can be personal property even if permanently attached.

An asset or component may qualify as tangible personal property under more than one criterion (movability, accessorital, or function). Each criterion should be recognized as support for the preferred personal property classification. For example, kitchen fixtures are supported by all three criteria: (1) Movability, (2) Accessory and (3) Function.

Planning for Movability - make components movable. Of the above three criteria, you have the most control with movability which why it is generally the most important of the three criteria. So the tax reduction planning is when you construct or rehab instead of making them totally permanently affixed to the building, make certain components movable so they qualify for the quicker, larger 5 year deduction. Examples of such components that can be made movable are interior walls, cabinets, shelving, storage bins, storage sheds.
Planning for *Accessory and Function* – know which components qualify; install if needed. With these you have less control than movability. The best planning is to know which components qualify under these criteria; and, if needed for your business, install them.

Just because a component is considered real under local law, does not mean it does not qualify under the tax law. In fact the tax law is more liberal and items long thought to be real are personal and eligible for the larger deductions and savings. Regulation 1.48-1(c) which states “Local law shall not be controlling for purposes of determining whether property is or is not personal. Property may be personal property even if under local law the property is considered a fixture and therefore real property”. This is further supported by a 1962 Senate report: “Tangible personal property is not intended to be defined narrowly here, not to necessarily follow rules of state law. Sen. Rep. 1881, 87th Cong, 2d sess, 1962.

When in doubt call it personal. Whether a component is real property (27-1/2 or 39 yrs.) or personal property (5 yrs.) is not always clear. Therefore, if you are uncertain if an item is real or personal, call it personal for more deductions and savings.

Reference source (return tab): – *Chapter 12*
## APPENDIX A-1: IRS MACRS\DEPRECIATION TABLES [Half-Year (1/2) Convention]

### Table 1 -- 5-YEAR PERSONAL PROPERTY

<table>
<thead>
<tr>
<th>Year</th>
<th>A. Accelerated</th>
<th>B. Straight-line</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>20.00%</td>
<td>10.00%</td>
</tr>
<tr>
<td>2</td>
<td>32.00</td>
<td>20.00</td>
</tr>
<tr>
<td>3</td>
<td>19.20</td>
<td>20.00</td>
</tr>
<tr>
<td>4</td>
<td>11.52</td>
<td>20.00</td>
</tr>
<tr>
<td>5</td>
<td>11.52</td>
<td>20.00</td>
</tr>
<tr>
<td>6</td>
<td>5.76</td>
<td>10.00</td>
</tr>
<tr>
<td>7</td>
<td>-----</td>
<td>-----</td>
</tr>
<tr>
<td>8</td>
<td>-----</td>
<td>-----</td>
</tr>
</tbody>
</table>

### Table 2 -- 15-YEAR LAND IMPROVEMENTS

<table>
<thead>
<tr>
<th>Year</th>
<th>A. Accelerated</th>
<th>B. Straight-line</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>5.00%</td>
<td>3.33%</td>
</tr>
<tr>
<td>2</td>
<td>9.50</td>
<td>6.67</td>
</tr>
<tr>
<td>3</td>
<td>8.55</td>
<td>6.67</td>
</tr>
<tr>
<td>4</td>
<td>7.70</td>
<td>6.67</td>
</tr>
<tr>
<td>5</td>
<td>6.93</td>
<td>6.67</td>
</tr>
<tr>
<td>6</td>
<td>6.23</td>
<td>6.67</td>
</tr>
<tr>
<td>7</td>
<td>5.90</td>
<td>6.67</td>
</tr>
<tr>
<td>8</td>
<td>5.90</td>
<td>6.67</td>
</tr>
<tr>
<td>9</td>
<td>5.91</td>
<td>6.67</td>
</tr>
<tr>
<td>10</td>
<td>5.90</td>
<td>6.67</td>
</tr>
<tr>
<td>11</td>
<td>5.91</td>
<td>6.67</td>
</tr>
<tr>
<td>12</td>
<td>5.90</td>
<td>6.67</td>
</tr>
<tr>
<td>13</td>
<td>5.91</td>
<td>6.67</td>
</tr>
<tr>
<td>14</td>
<td>5.90</td>
<td>6.67</td>
</tr>
<tr>
<td>15</td>
<td>5.91</td>
<td>6.67</td>
</tr>
<tr>
<td>16</td>
<td>2.95</td>
<td>3.33</td>
</tr>
</tbody>
</table>

### Table 3 -- 10-YR. SINGLE PURPOSE FARM BUILDGS

<table>
<thead>
<tr>
<th>Year</th>
<th>A. Accelerated</th>
<th>B. Straight-line</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>10.00%</td>
<td>5.00%</td>
</tr>
<tr>
<td>2</td>
<td>18.00</td>
<td>10.00</td>
</tr>
<tr>
<td>3</td>
<td>14.40</td>
<td>10.00</td>
</tr>
<tr>
<td>4</td>
<td>11.52</td>
<td>10.00</td>
</tr>
<tr>
<td>5</td>
<td>9.22</td>
<td>10.00</td>
</tr>
<tr>
<td>6</td>
<td>7.37</td>
<td>10.00</td>
</tr>
<tr>
<td>7</td>
<td>6.55</td>
<td>10.00</td>
</tr>
<tr>
<td>8</td>
<td>6.55</td>
<td>10.00</td>
</tr>
<tr>
<td>9</td>
<td>6.56</td>
<td>10.00</td>
</tr>
<tr>
<td>10</td>
<td>6.55</td>
<td>10.00</td>
</tr>
<tr>
<td>11</td>
<td>3.28</td>
<td>5.00</td>
</tr>
</tbody>
</table>

### Table 4 -- 20-YR. OTHER FARM BUILDINGS

<table>
<thead>
<tr>
<th>Year</th>
<th>A. Accelerated</th>
<th>B. Straight-line</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3.75%</td>
<td>2.5%</td>
</tr>
<tr>
<td>2</td>
<td>7.219</td>
<td>5.0</td>
</tr>
<tr>
<td>3</td>
<td>6.677</td>
<td>5.0</td>
</tr>
<tr>
<td>4</td>
<td>6.177</td>
<td>5.0</td>
</tr>
<tr>
<td>5</td>
<td>5.713</td>
<td>5.0</td>
</tr>
<tr>
<td>6</td>
<td>5.285</td>
<td>5.0</td>
</tr>
<tr>
<td>7</td>
<td>4.888</td>
<td>5.0</td>
</tr>
<tr>
<td>8</td>
<td>4.522</td>
<td>5.0</td>
</tr>
<tr>
<td>9</td>
<td>4.462</td>
<td>5.0</td>
</tr>
<tr>
<td>10</td>
<td>4.461</td>
<td>5.0</td>
</tr>
<tr>
<td>11</td>
<td>4.462</td>
<td>5.0</td>
</tr>
<tr>
<td>12</td>
<td>4.461</td>
<td>5.0</td>
</tr>
<tr>
<td>13</td>
<td>4.462</td>
<td>5.0</td>
</tr>
<tr>
<td>14</td>
<td>4.461</td>
<td>5.0</td>
</tr>
<tr>
<td>15</td>
<td>4.462</td>
<td>5.0</td>
</tr>
<tr>
<td>16</td>
<td>4.461</td>
<td>5.0</td>
</tr>
<tr>
<td>17</td>
<td>4.462</td>
<td>5.0</td>
</tr>
<tr>
<td>18</td>
<td>4.461</td>
<td>5.0</td>
</tr>
<tr>
<td>19</td>
<td>4.462</td>
<td>5.0</td>
</tr>
<tr>
<td>20</td>
<td>4.461</td>
<td>5.0</td>
</tr>
<tr>
<td>21</td>
<td>2.231</td>
<td>2.5</td>
</tr>
</tbody>
</table>

**IRS DEPRECIATION MACRS TABLES FOR REAL PROPERTY (BUILDING)**
### Table 5

Residential Rental Property (Building) - 27-1/2 Years (Straightline) -- For Property Placed In Service From January 1, 1987 To The Present

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>3.485</td>
<td>3.182</td>
<td>2.879</td>
<td>2.576</td>
<td>2.273</td>
<td>1.970</td>
<td>1.667</td>
<td>1.364</td>
<td>1.061</td>
<td>0.758</td>
<td>0.455</td>
<td>0.152</td>
</tr>
</tbody>
</table>
| 29   | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.152 | 0.455 | 0.758 | 1.061 | 1.364 | 1.667 |-------

[NOTE: The above are percentages. For example, a property is acquired on January 1 and $100,000 is allocated to the building. The depreciation for the first year is $3485 ($100,000 x 3.485%). The depreciation for the second year is $3636 ($100,000 x 3.636%).]

### Table 6

Non-Residential Rental Property (Building) - 39 Years (Straightline) -- For Property Placed In Service From May 13, 1993 To The Present

<table>
<thead>
<tr>
<th>Year</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
<th>6</th>
<th>7</th>
<th>8</th>
<th>9</th>
<th>10</th>
<th>11</th>
<th>12</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>2.461</td>
<td>2.247</td>
<td>2.033</td>
<td>1.819</td>
<td>1.605</td>
<td>1.391</td>
<td>1.177</td>
<td>0.963</td>
<td>0.749</td>
<td>0.535</td>
<td>0.321</td>
<td>0.107</td>
</tr>
<tr>
<td>2-39</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
<td>2.564</td>
</tr>
<tr>
<td>40</td>
<td>0.107</td>
<td>0.321</td>
<td>0.535</td>
<td>0.749</td>
<td>0.963</td>
<td>1.177</td>
<td>1.391</td>
<td>1.605</td>
<td>1.819</td>
<td>2.033</td>
<td>2.247</td>
<td>2.461</td>
</tr>
</tbody>
</table>

For more about depreciation and IRS depreciation tables, refer to IRS Publication 946. Call IRS at 1-800-829-3676. **ALERT:** Only ask for publications or forms. Do NOT ask for tax advice.
APPENDIX A-2:

Repairs Vs. Improvements - Interaction With Other Areas Of Tax Law, More Tax Planning Strategies

The repairs vs. improvement controversy can be so significant that it can interrelate with other areas of tax law. Four of these areas are as follows:

1. NET OPERATING LOSS ("NOL") (IRC 172)

2. CASUALTY LOSS DEDUCTION (IRC 165)

3. REHABILITATION TAX CREDITS FROM IMPROVEMENTS TO OLDER OR HISTORIC BUILDINGS (IRC 47)

4. IF THE PROPERTY IS A PERSONAL RESIDENCE.

1. NET OPERATING LOSS ("NOL") (IRC 172): Basically, an NOL happens when your business and rental property losses exceed all of your other income resulting in a negative taxable income. If your “total income” on page 1 of your 1040 (on about line 22) is a negative amount, then most likely you have an NOL. An “NOL” is not just a loss, such as a Schedule C, Schedule E loss or form 1065 loss. It is a loss in excess of your other income. and results from business losses, rental losses and casualty losses. (NOL’s are further discussed in Chapter 28.)

The benefit of an NOL is that it can be carried back 2 to recoup past due taxes or carried forward to offset future taxable income (and save taxes). Deductible repairs are business expenses, which increase business losses and an NOL.
Therefore, the more deductible repairs you have, the higher the NOL. In this case, repair classification is more advantageous.

On the other hand, without an NOL, we may prefer capital improvement classification because an important part of tax reduction planning is not wasting deductions. This is especially so when you are in what I call a “limbo layer of deductions”. This is where your present business and rental loses are enough to offset most of your other income, but not all of it. However, whatever other income is not offset by business losses is offset by your itemized deductions and personal exemptions. In this situation you will not have an NOL. Here, you really do not need any more deductions. Any more may be wasted if used in the current year.

You therefore should save deductions for future years. Instead of expensing repair items, you can treat them as capital improvements and depreciate them over a number of years. The result of this type of planning is that you “bank” your deductions for future years, instead of wasting them into “limbo”. See Chapter 28 for a further discussion.

2. CASUALTY LOSS DEDUCTION (IRC 165): A casualty loss is the damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual (such as a fire or flood). Personal casualty losses are subject to significant limitations in that they cannot exceed 10% of adjusted gross income and then must be reduced by $100. However, casualty losses in relation to an investment property are considered a business casually loss and are therefore not subject to these limitations.

The measure of the business casually loss deduction could be the adjusted basis of the property destroyed, less insurance or other reimbursement proceeds, Reg. 1.165-7(b)(1). However, there is an alternate way - the cost of repairs to restore the property to its original condition can also be considered a measure of the
amount of the casually loss deduction, if you repair the property to its pre-casualty condition, without materially improving it, Reg. 1.165-7(a)(2)(ii).

**Planning Tip For A Double deduction:** Chapter 12-C (on componentizing) discusses why you should segment the building into its structural components. If you do this and also use the cost of the repairs as the measure of the casualty loss, I see the planning opportunity for a double deduction as follows:

(1) A retirement loss deduction* in the amount of the remaining adjusted basis of the destroyed component, Reg. 1.167(a)-8; Reg. 1.263(a)-2(a); RR 68-104. See Section 14. (*Note: You do not write this off as a casualty loss); and

(2) A business casualty loss deduction, the repairs costs to restore the damaged property, Reg. 1.165-7(a)(2)(ii). This is the casualty loss deduction.

**EXAMPLE 1:** You purchase a property and for depreciation purposes, componentize the property into its various structural improvements (see Section 14). Included in this component breakdown is the heating system which has an original component basis of $8,000. After several years of ownership, a fire almost completely destroys the heating system. At the time of the casualty, the adjusted basis of the heating system is $6,600 and its salvage value is $500. You therefore should write off $6,100 as a retirement loss deduction (not a casualty loss), as per (1) above. The costs necessary to restore the heating system to its original condition are $9,000, less insurance of $6,000 leaves a net loss of $3,000. The $3,000 net repairs is a casualty loss deduction under Reg. 1.165-7(a)(2)(ii).

**Result:** Two deductions equaling one total deduction of $9,100; (1) The retirement loss deduction of the destroyed component of $6,100 and (2) The casualty loss deduction of $3,000 based on the repair costs. (See also R.R. Hensler Inc. 73 TC 168.)
3. REHABILITATION TAX CREDITS FROM IMPROVEMENTS TO OLDER OR HISTORIC BUILDINGS (IRC 47): These dollar-for-dollar credits arise from capital improvements and not repairs. In this scenario, it may be more advantageous to treat expenditures as capital improvements instead of repairs. Which will be more beneficial (credit or repair) will largely depend on the entrepreneur’s tax bracket. Generally, the lower the tax bracket the more advantageous is the credit versus the repair, provided there is enough of an income tax liability which the credit can offset. On the other hand, the higher the tax bracket the more valuable deductions become.

EXAMPLE 2: JR incurs $45,000 of expenditures to his property. Assume JR is in a maximum tax bracket of 15% and is entitled to a 20% rehab credit of $9,000. If JR treats the expenditures as repairs (and forgoes the credit), his tax savings will be $6,750. However, with the credit his tax savings will be $9,000 (the credit itself), plus any tax savings from depreciation of the capital improvements. In this case the credit is more beneficial. If JR were in a 31% tax bracket, then his tax savings from a repair deduction of $45,000 would be $13,950. Here, the repair deduction is better than the credit.

NOTE: The other factor that needs to be considered is whether the expenditures are really capital improvements and not repairs. While this is quite controversial, there are situations where expenditures are mostly likely capital improvements (discussed in the last sections). Capital improvements generally include new additions to a building and other major renovations or construction, IRC 263; Human Engineering Institute, TC Memo 1978-45; LaPoint, (1990) 94 TC 733. Expenditures to adapt a property to a new or different use are capital, Reg. 1.263(a)-1(b). At least up to a certain cut-off date, capital improvements include those that put property into an ordinary efficient operating condition and are generally made upon acquisition when the property requires substantial rehabilitation before it can be made into a safe and habitable condition. For these qualifying capital improvements, there are the rehabilitation tax credits, which are further discussed in Chapter 20.
4. IF THE PROPERTY IS A PERSONAL RESIDENCE. Here, capital improvements can be added to basis which in turn reduces capital gain. On the other hand, repairs to a personal residence (including second homes) provide no tax benefit as they are not deductible at all, IRC 262.

**TAX TIP:** When you want expenditures to be considered capital improvements, see Goldmine Chapter 18-A.
APPENDIX B: Passive Loss Limits (PAL)- Other Issues And More Planning Strategies
By: Albert Aiello, CPA, MST

Contents

1. ACTIVITIES THAT ARE NOT PASSIVE RENTAL ACTIVITIES

2. MORE WAYS TO BYPASS PASSIVE LOSS LIMITATIONS - STRATEGIES TO GENERATE PASSIVE INCOME FROM WHICH YOU CAN USE TO OFFSET PASSIVE LOSSES (OR CREDITS) FROM OTHER PROPERTIES

3. SCHEDULE OF PHASE-OUT OF $25,000 PASSIVE LOSS LIMIT FOR AGI BETWEEN $100,000 AND $150,000, IN INCREMENTS OF $5,000

4. RECHARACTERIZATION RULES TO PREVENT PAL INCOME

5. NET LEASE PROPERTIES AND ACTIVE PARTICIPATION

6. RAW LAND AND ACTIVE PARTICIPATION

7. PAL LIMITS AND PARTNERS IN A PARTNERSHIP

8. THE $25,000 LOSS ALLOWANCE ALSO PERTAINS TO TAX CREDITS

9. ALERT ON ORDERING RULES - FIRST TO PAL LOSSES, SECOND TO PAL CREDITS

1. ACTIVITIES THAT ARE NOT PASSIVE RENTAL ACTIVITIES AND NOT SUBJECT TO PAL LIMITS
(1) Active real estate businesses materially participating in the management of the property, IRC 469(c)(7). Here, rental losses are deductible without limit. For a further discussion see Chapter 26.

(2) Dealer activities in real estate [see Reg. 1.469-1T(c)(2)(v)]. Such activities generally include profits from the full-time business of quickly flipping properties and property development. Dealers are not entitled to those powerful depreciation deductions. Therefore, with the combination of flip profits and no depreciation, dealer properties will generally not show tax losses. Accordingly, PAL limitations will not be a problem. On the other hand don’t jump at the chance to call yourself a dealer. There can be significant disadvantages in being considered a “dealer” as opposed to an “investor”. For a further discussion of this very gray area, see Chapters 41 to 43A and Appendix E.

(3) When the average tenant use is 7 days or less. This exception essentially includes hotel or motel types of operations. For a further discussion, see Reg. 1.469-1T(e)(3)(iii)

Note: See the tax alert about hotel-condos, below, following the discussion of these exceptions.

(4) When the average tenant use is greater than 7 days but not greater than 30 days and where significant services are provided. “Significant services” include maid service, room service, registration service, etc. Significant services do not include repairs, cleaning, maintenance, trash removal, elevator services, security or other services that are commonly provided with long-term rentals of high-grade commercial or residential property. For a further discussion, see Reg. 1.469-1T(e)(3)(iv). Note: See the tax alert about hotel-condos, below, following the discussion of these exceptions.

(5) When the rental of property is “incidental” to the business activity. This relief provision applies to three activities:
(a) Property that is held for investment appreciation and renting it is only incidental to holding the property. A prime example here would be holding land for the primary purpose of appreciation and also renting it during the holding period. Here, the gross rent income must be less 2% of the lesser of the property’s unadjusted basis or fair market value. For a further discussion, see Reg. 1.469-1T(e)(3)(vi)(B).

(b) The occasional renting out of idle business-use property. For example, a property used as a real estate office, temporarily rents out space to non-RE agents. (Such space is normally used by the real estate agents in the office). There is also a 2% rule here. For a further discussion, see Reg. 1.469-1T(e)(3)(vi)(C).

(c) Lodging is furnished for the convenience of an employer. This involves providing the employees lodging for the employer’s convenience (IRC 119) and this is incidental to the business of the taxpayer in which the employee performs services for. For a further discussion, see Reg. 1.469-1T(e)(3)(vi)(D).

(d) Other exceptions are not very relevant to this publication. For a further discussion, see Regulations 1.469-1T(e)(3)(ii)(E), 1.469-1T(e)(3)(v) and 1.469-1T(e)(3)(ii)(F).

**TAX ALERT:** Pertaining to the above exceptions (3) and (4), be aware of hotel-condos, with short-term rentals for writing off property losses. These are properties that are rented for periods averaging 7 days or less; or greater than 7 days but not more than 30 days, where significant services are provided. According to Reg. 1.469-4(b)(2) these types are not considered a “rental activity” where the taxpayer can come under the $25,000 passive loss relief provision, including meeting the requirement of “active” management participation.
In a recent case, the taxpayers rented out their hotel-condo using the company that managed the complex to handle reservations, book the rentals, supply the front desk staff, housekeeping and maintenance services. *Result:* Because these are not considered rental activities as per exceptions (3) and (4), they are not entitled to the $25,000 loss deduction. They are subject to passive loss limits and their current loss is not currently deductible but must be suspended. *Barnkiskis,* TC Memo 1999-258.

**TIP:** Prove material participation in managing the property. Here, the only way the taxpayer can be entitled to loss deductions is come under exception (1) above, as an active real estate business materially participating in the management of the property (See Chapter 26). In the above case, the taxpayer visited the premises occasionally but, could not meet the 500 or 100 hours test as required by this exception. Moreover, they also must meet the 51% and 751 hour tests for active real estate businesses. With the above types of hotel-condo arrangements, these can be difficult tests to meet. For independently owned vacation home rentals, meeting these tests will be easier. Whatever the case may be, the best way to try to accomplish this is to use the *Goldmine* forms (on computer disk), *Weekly Summary of Real Property Business Activities* (FMOPSBUS) and *Weekly Summary of Landlord-Management Activities* (FMOPSMGT). Again, refer to Chapter 26.

2. MORE WAYS TO BYPASS PASSIVE LOSS LIMITATIONS - STRATEGIES TO GENERATE PASSIVE INCOME FROM WHICH YOU CAN USE TO OFFSET PASSIVE LOSSES (OR CREDITS) FROM OTHER PROPERTIES

**STRATEGY 1:** Acquire “pigs” (passive income generators), every “PAL” needs a “PIG” -- “Pigs” are net passive income properties. They are properties that have such a substantial positive cash-flow, that the property will show a net taxable income, instead of a net tax loss. Such net taxable income is passive
income from which you can use to offset passive losses from other properties. Examples of potential “cash-cows”: Mini-storage units, mobile home parks, lower-end residential housing or any other property that you acquire with low cost financing, less leverage, substantially below market, and/or have the ability to substantially increase its net cash flow.

**ALERT 1: Publicly Traded Partnerships** - Net income from these are *not* considered passive income from which you can use to offset passive losses from other properties. Instead, it is considered to be portfolio income which can *not* be reduced by passive losses, IRC 469(k)(1). A publicly traded partnership is a partnership whose interests are traded in an established securities market or readily tradable in a secondary market, IRC 469(k)(2).

**ALERT 2: Recharacterization Rules** - These are rules to prevent taxpayers from artificially creating PIG’s or passive income generators, which can be used to accelerate the use of passive losses. See Part 4 in this appendix for a further discussion.

**STRATEGY 2: Sell a partial interest in the property** -- Partial taxable gains are considered to be passive income from which you can use to offset passive losses from other properties. (See Senate Finance Committee Report of TRA 1986, page 719). Partial taxable sales can be accomplished by:

(a) Selling a partial interest to a tenant in a “shared equity” arrangement. Equity sharing also has other non-tax advantages, such as eliminating negative cash flows, bad tenants, vacancies and maintenance. [See IRC 280A (d)(3)(C) for meeting shared equity requirements.]

(b) Selling a partial interest (such as 1/4) to an investor/partner.
(c) Selling a partial interest to someone that the taxpayer knows*, such as a relative, friend, or even an entity in which the investor has an ownership interest in, such as a partnership or corporation. (See tax tip alert below*)

(d) Debt restructuring and partial cancellation of debt can result in taxable income, which can be passive income from which you can use to offset passive losses from other properties. See Reg. 1.163-8T and RR 92-92. Also, see Strategy 3, on the next page.

*ALERT: Partial taxable sales are generally not subject to any technical related party rules. However, such closely related transactions may be subject to closer IRS scrutiny. Accordingly, the validity of such sales should be at an arms-length sales price and terms, backed up by comparable sales or appraisal. Also, all parties should be legally bound with proper documentation. Check with legal counsel.

TIP: Partial sales are also a way to generate additional cash.

TAX TIP: Partial sales should be done as all-cash sales as opposed to taking back a note via an Installment Sale* under IRC 453. Reason: All cash sales create the needed passive income. (*See Chapter 25 for the effect of installment sale on passive losses.)

STRATEGY 3: Pay down property debt - The investor can do this by paying down the mortgage debt on the property. If interest on the debt is causing the investment property to generate a tax loss, then paying off some or all of this debt reduces the interest which in turn reduces passive losses or generates taxable passive income. Suspended losses from prior years could shelter the new passive income, or losses from other passive activities could offset this passive income.
EXAMPLE 1: You have a $75,000, 12% mortgage on a property. The annual interest deduction is $9,000. The property shows a passive tax loss of $5,000 after deducting the $9,000 of interest. You also have other unused passive losses of $4,000. If you pay off the mortgage, you eliminate the $9,000 interest and your $5,000 passive loss turns into $4,000 of passive income, from which you can now offset the unused passive losses of $4,000.

**TIP:** Sell off or convert portfolio assets into cash, which can be used to pay off the debt. For purposes of this provision, portfolio assets are investments such as stocks, bonds, and savings accounts which generate dividend and interest income. Not only will selling (or converting) these investments give you the necessary cash to pay down debt, it will reduce the investment’s portfolio income (dividends, interest, etc.). Such portfolio income cannot be used to shelter passive losses. In effect, you are reclassifying portfolio income into passive income. Note: Included here is the net income from a publicly traded partnership, which is also considered to be portfolio income as previously discussed under Strategy 1 above.

**MONEY TIP:** Before doing the above you need to assess the tax and economic consequences of converting these assets into cash. In investor terminology, the process of paying down debt is sometimes referred as “deleveraging”, which saves on interest costs. Whether an investor wants to deleverage (or leverage) should be part of an overall plan of investment objectives and not just limited to tax considerations.

**STRATEGY 4: Use a home equity loan of up to $100,000** -- If the investor uses a home equity loan of up to $100,000 to pay off the mortgage on the investment property, the interest on the equity loan will be separately deductible on IRS Schedule A - Itemized Deductions. It will not be deducted on the rental property tax form. Therefore, the Schedule A interest is not at all subject to any passive loss limitations. This strategy effectively produces the same tax effect as Strategy 3 above.
STRATEGY 5: IF the rental properties are showing taxable income, then flunk the tests of the 1993 relief provision allowing active RE professionals to fully deduct rental losses without being subject to pal limits - *Reason*: The net income is considered to be *active* income which can not be reduced by passive losses. By flunking these tests, the net income is passive income which can offset passive losses.

IMPORTANT NOTE: On the other hand if the rental operations are showing losses, then totally bypass PAL limitations by using this relief provision, discussed in Chapter 26.

3. SCHEDULE OF PHASE-OUT OF $25,000 PASSIVE LOSS LIMIT FOR AGI BETWEEN $100,000 AND $150,000, IN INCREMENTS OF $5,000

<table>
<thead>
<tr>
<th>Adjusted Gross Income</th>
<th>Loss Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$105,000</td>
<td>$22,500</td>
</tr>
<tr>
<td>110,000</td>
<td>20,000</td>
</tr>
<tr>
<td>115,000</td>
<td>17,500</td>
</tr>
<tr>
<td>120,000</td>
<td>15,000</td>
</tr>
<tr>
<td>125,000</td>
<td>12,500</td>
</tr>
<tr>
<td>130,000</td>
<td>10,000</td>
</tr>
<tr>
<td>135,000</td>
<td>7,500</td>
</tr>
<tr>
<td>140,000</td>
<td>5,000</td>
</tr>
<tr>
<td>145,000</td>
<td>2,500</td>
</tr>
<tr>
<td>150,000 or more</td>
<td>none</td>
</tr>
</tbody>
</table>

($25,000 less $2,500 or 1/2 of $ 5,000)

($25,000 less $5,000 or 1/2 of $10,000)

($25,000 less $7,500 or 1/2 of $15,000)

($25,000 less $10,000 or 1/2 of $20,000)

($25,000 less $12,500 or 1/2 of $25,000)

($25,000 less $15,000 or 1/2 of $30,000)

($25,000 less $17,500 or 1/2 of $35,000)

($25,000 less $20,000 or 1/2 of $40,000)

($25,000 less $22,500 or 1/2 of $45,000)

4. RECHARACTERIZATION RULES TO PREVENT PAL INCOME

These are rules to prevent taxpayers from artificially creating PIG’s or passive income generators, which can be used to accelerate the use of passive losses.
One example is renting your building to your own corporation, in which you materially participate. This will not create passive income, which can offset passive losses, Reg. 1.469-2(f)(6); Connor, TC Memo. 1999-185; Krukowski, 114, TC 25. For other examples, refer to Regulations 1.469-2T(f), 1.469-1T(f), 1.469-2(c)(2)(iii), 1.469-2(c)(2)(iii)(D), 1.469-2T(c)(2)(iii)(A), 1.469-2T(c)(3)(iii)(A).

5. NET LEASE PROPERTIES AND ACTIVE PARTICIPATION

One of the requirements for coming under the $25,000 loss allowance exception is that the property owner must “actively participate” in the management of the property, IRC 469(I)(6). This may be a problem for owners of net lease properties. Net lease properties are those that have a long term lease with a commercial tenant, usually with excellent credit. The tenant is responsible for almost all operating & maintenance costs and the owner receives a net rent check. Typically the tenant will pay additional rent for all increases in operating expenses including property taxes and insurance.

PAL Impact: Because the tenant is responsible for almost all operating & maintenance costs, the owner may not meet this active requirement for reaping the $25,000 loss allowance (Senate Rep. No. 99-33 (PL 99-515, p. 738). For this PAL provision, the term “net lease” is not defined in Section 469. However, the IRS Passive Activity Audit Guide does address a “net lease” as one in which the tenant pays for most of all of the expenses. The audit guide further states that a net lease exists when (a) deductions (other than interest, taxes and depreciation) are less than 15% of gross rents; or (c) the lessor is guaranteed a specific return against loss of income. (Note: This definition arises from the pre-1986 law concerning investment interest.). On the positive side, net lease properties may show positive net taxable income, which is passive income from which you can use to offset passive losses from other properties.
TAX TIP -- NET LEASE PROPERTIES: If the property will show a net rental loss which the investor wants to currently deduct -- try to meet the active participation by incorporating into the rental agreement that the landlord has a “final say” on at least the larger property expenditures or decisions. (See Chapter 25.) Based on the above, it would also help to show operating expenses as being 15%* or more than gross rents. This may not be an easy task with net lease properties, especially “triple-net lease” properties.

*NOTE: The above 15% test comes from IRS audit guides which first off, stem from another provision (investment interest), and such guides do not have the force of law. Otherwise, if the property will show a net rental income, these planning strategies will not be necessary, because such net rental income is passive income from which you can use to offset passive losses from other properties.

6. RAW LAND AND ACTIVE PARTICIPATION

It appears that holding raw land is not a passive activity because land is not considered a “business” activity, IRC 469(c)(6), IRC 469(j)(1). If it is not a passive activity, losses from carrying the land can be offset against other income, such as business income, salaries, interest and dividends. However, if the land is rented, then it may become a rental activity subject to PAL limitations, unless the rental is “incidental” to holding the land as an investment. See Part I of this appendix and Temp. Reg. 1.469-1T(e)(3)(ii)(D).

NOTE: Because there will be no (or little) depreciation write-offs, rented land most likely will generate net taxable rent income. Here, if the rented land is a passive activity, then the net taxable rent income is passive income, which can be fully offset by unused passive losses.

7. PAL LIMITS AND PARTNERS IN A PARTNERSHIP
General partners are subject to PAL limitations, but can bypass them with either the exceptions of the $25,000 loss allowance (Chapter 25) or active real estate businesses (Chapter 26). However, for the most part, limited partners in a limited partnership are totally subject to PAL limitations, without use of these exceptions IRC 469(h)(2). Therefore, a limited partner’s share of rental losses cannot offset other income, such as salaries, business, income, interest, dividends, etc. They can only offset other passive income, namely net taxable rentals and gains from the disposition of the rental property.

If an individual is both a limited partner and also a general partner, then regulations do not split the two partner capacities. Instead the limited partnership interest is treated as a general partnership interest, Temporary Reg. 1.469-5T(e)(3)(ii). This means that the limited partnership interest will receive the more favorable treatment of a general partner. However, from a practical standpoint this may not be too useful, because in most limited partnerships the general partnership interest is very small (as low as 1%) and the general partner(s) may be a corporation, which has its own set of loss limitations for real estate investors. There are also adverse legal consequences as per the “liability-trap” below.

There is also another exception where a limited partner can elect not be treated as a limited partner and bypass these passive loss limits by falling within any one of the following three exceptions: (1) By participating 501 or more hours per year (or about 10 hours a week), or (2) The limited partner participated for five of the last ten years, or (3) The limited partner participated for any three years in a personal service activity.

**LIABILITY-TRAP**: However, if the limited partner participates in the management of the business, then they will be subject to the same personal liability of a general partner and thus defeat the primary purpose of the limited partnership > limited liability. In fact, the word “limited” must be used in the
name of the partnership. Failure to do so will cause all partners (including limited partners) to be personally liable. See Section 5.

8. THE $25,000 LOSS ALLOWANCE ALSO PERTAINS TO TAX CREDITS

The $25,000 loss-deduction allowance limit also applies to tax credits pertaining to rental real estate. Such tax credits include rehabilitation tax credits to older or historic buildings (IRC 47) and low-income housing tax credits (IRC 42). To do this, the tax credits are converted to what the equivalent-loss-deduction would be, IRC 469(i)(1); IRC 469(j)(5).

That is, you can claim the credits but only up to the “deduction-equivalent” of the $25,000 loss limit. To convert the credit into a loss-deduction equivalent, employ the following steps:

(1) Find out your loss deduction limit. If your AGI is $100,000 or less (and you meet the other tests) the loss limit is the full $25,000. Under the phase out, if your AGI is over $100,000 but less than $150,000, the $25,000 limit will be less according to the schedule in Part 3 in this section. If your AGI is over $150,000 then there is no current loss deduction or current use of the tax credit under these rules.

(2) Compute how much the loss deduction limit (arrived at in step 1) would save you in taxes by determining the difference in taxes without, and with the loss deduction.

(3) This difference in tax savings is the maximum credit you can claim for the current year.
EXAMPLE 2: Your AGI is $100,000 (or lower) and you have full use of the $25,000 loss deduction; your properties are generating net taxable income and not PAL losses (the reason for this will be explained in Part 9, on the next page); your taxable income for the year is $70,000 (without the $25,000 deduction). Using the IRS tables (married-joint) the tax on this amount is $14,102. After the $25,000 loss deduction your taxable income is $45,000 and the tax liability is $7,102. The difference between $14,102 and $7,102 is $7,000 which is the limit on the amount of credit you can claim for the current tax year. Any credit amounts above this are suspended and carried forward.

TAX BREAK: Section 469 does not mention the Disabled Access Credit for expenditures incurred for the handicapped under IRC 44 (See Chapter 21A). Presumably it should, as IRC 469(I)(1) does state passive activity credits attributable to all rental real estate activities.

ALERT ON UNUSED TAX CREDITS: Unused tax credits (such as rehab and low-income housing credits) may be totally lost upon the full disposition of the property. That is, you cannot offset any such unused credits against the gains on the final sale the entire property. These valuable credits disappear!

TIP 1: Hold off on selling the property and use the tax credits to offset passive income, other than gains on the sale of the entire property. Such passive income would include net taxable rental income and sales of partial interests in rental property (discussed in Part 2 of this appendix). Therefore, properties qualifying for these tax credits should be ones that show a healthy positive cash flow from operations. See Chapters 20 & 21 for a further discussion of rehab and low-income housing credits.

TIP 2: Meet the tests of the 1993 relief provision allowing active real estate entrepreneurs to fully deduct rental losses (and tax credits) without being subject to any passive loss limits regardless of income. This provision also includes tax credits not being subject to PAL limits. See Chapter 26.
9. ALERT ON ORDERING RULES - FIRST TO PAL LOSSES, SECOND TO PAL CREDITS

In using the $25,000 loss allowance, it is first applied to rental property losses and then to rehabilitation tax credits (IRC 47) and then to low-income housing tax credits (IRC 42). See IRC 469(i)(3)(D). This means that if your rental properties are showing losses and are also entitled to these tax credits, the $25,000 loss limit is first applied against the rental loss, and then whatever of the $25,000 is remaining is applied to the credits. If the rental losses exceed the loss limit, then none of the credits could be currently claimed. They are suspended and carried forward.

EXAMPLE 3: Your rental property losses are $25,000, which is your deduction limit. The properties also are entitled to rehab credits of $4,000 under IRC 47. Because you must first use the $25,000 deduction limit toward your rental property losses of $25,000, none of the $4,000 credits could currently be claimed. They are therefore suspended and carried forward. See the two planning tips below.

TIP 1: Where you are entitled to claim these tax credits, look for significant cash flow properties that do not generate significant tax losses or even better, positive cash flow and taxable income. This will free up the $25,000 loss limit for the tax credits.

TIP 2: Totally bypass PAL limits by meeting the tests of being an active real estate entrepreneur as discussed in Chapter 26. By totally freeing yourself of these limits, all of your rental losses are fully and currently deductible regardless of your income. The same (limit-free) benefit applies to these tax credits.

Reference source (return tab): – Chapter 24
Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
APPENDIX B-1: Limitation On Deducting Rental Losses -- Buyer “At-Risk” Limitations With Non-Recourse Seller Financing (IRC 465) -- Planning Strategies To Bypass This Limitation

A. Purpose: The purpose of this provision is to put a limit on deducting rental losses where there is non-recourse seller financing.

B. First some basic real estate finance definitions: A recourse mortgage is where the debtor is personally liable on the debt. (Most mortgages are recourse.) On the other hand, a non-recourse mortgage is where the debtor is not personally liable on the debt. In the event of default, the lender takes only the property, not the other assets of the buyer. A non-recourse mortgage is also referred to as a “subject to” mortgage or “exculpatory” mortgage. A non-recourse (or exculpatory) clause may read something like the following: “Default of this Agreement by the buyers or their heirs, personal representatives, or their assigns shall incur no personal liability of buyer or heirs, representatives, or assigns.” As a practical matter, non-recourse loans are usually given by larger commercial lenders or the seller* of the property. (*The latter is where this loss limitation mainly comes into play.)

C. At-Risk Rules - Limitations On Deductibility Of Rental Losses: As they pertain to real estate, the purpose of the “at-risk” limitations is to limit the deductibility of the amount of rental losses up to an amount that you have at-risk, which is: Your own cash or other property; recourse or non-recourse financing from a third-party lender; or recourse seller financing. However, the amount of non-recourse seller financing is not considered at-risk and this is where the loss limitations kick in. IRC 465(b)(6)(D); IRC 49(a)(1)(D).

EXAMPLE 1 - AT-RISK, NO LOSS LIMIT: You acquire a rental property for a price $100,000, with $5,000 down and a $95,000 mortgage from an institutional lender. (Because the mortgage is with a third-party lender, it does
not make any difference if the mortgage is recourse or non-recourse). At the end of the tax year the property shows a rental loss of $15,000. Barring any other loss limitations, you can deduct the entire rental loss as you are not subject to these at-risk limitations. *Reason:* The entire $100,000 price is at-risk with your own $5,000 as a cash down payment and a mortgage (recourse or non-recourse) with a third-party lender.

**EXAMPLE 2 - *NOT AT-RISK, THERE IS A LOSS LIMIT:*** Same facts as above except that the $95,000 mortgage is held by the seller as *non-recourse* debt. Again, at the end of the tax year the property shows a rental tax loss of $15,000. However, you can only deduct $5,000 as a tax loss, up to what you have at-risk, your cash down payment of $5,000. The remaining $10,000 loss is suspended and must be carried over until you have a sufficient amount at-risk, such as additional cash down or debt restructuring to recourse. *Reason:* The entire $95,000 non-recourse seller debt is not at-risk. The amount of suspended at-risk losses are carried forward indefinitely, Reg. 1.465-2(b). (According to Reg.1.465-67(b) it appears that any suspended at-risk losses disappear at death.)

**D. Planning Strategies For Bypassing At-Risk Limits With Non-Recourse Seller Financing:**

(1) Put more cash down. This will increase the loss, but may defeat the purpose of using leverage. However, more cash down means a lower loan payment. Moreover, the cash can come from someone else such as an equity partner or third-party lender.

(2) Use property other than cash for a down payment. The adjusted basis (not market value) of such property is considered to be at-risk, IRC 465(b)(1)(A). The property can be a car, boat, jewelry, etc. This is also considered part of “creative financing”.
(3) Split the seller financing into non-recourse and recourse financing, with just enough recourse financing to allow rental losses. At least, you will be personally liable on only part of the mortgage.

(4) Split the property title between the land and the building improvements. You then have two deeds, one for the land and the other for the building improvements. You lease the land from the seller, with an option to buy; and obtain non-recourse financing from a third-party lender for the building improvements. With this approach, there are no at-risk limits at all because you use non-recourse third-party financing for the building and a lease for the land with the seller which is not technically seller financing.

(5) Lease the property with the right to sublet and an option to buy. This is known as a “sandwich lease” which is an indirect form of seller financing. However, if this arrangement is structured as a true “lease” and a true “option”, there is no formal seller financing and thus no at-risk limits. Of course, you do not own the property and therefore are not entitled to depreciation deductions. However, you “control” the property and therefore still can profit from positive cash flow and resale profits. (Note: Sandwich or master leases can be very lucrative. For more above leases-options, see the Goldmine, Section 40)

E. At-Risk Rules -- Other Issues With Non-Recourse Loans Along With Planning Strategies

**Alert:** If the non-recourse financing is from a third-party lender, who is related* (see below) to the taxpayer, then the loan should be fully documented as an arms-length transaction with substantially the same terms as other loans with other unrelated parties. **Reason:** If it is not, then the loan will not be considered at-risk and these loss limitations will come into play. IRC 49(a)(1)(D)(I); IRC 465 (b)(3). If feasible, another planning strategy is to transact with one of the unrelated parties, listed below.
A. The following are “related parties” for the above rule: *Under IRC 267(b) “related parties” include spouses, parents, grandparents, children, grandchildren, brothers, sisters and more than 10% (not 50%) owned entities such as corporations, partnerships, trusts, etc.

B. However, the following are not “related parties” for the above rule: Aunts, uncles, cousins, nieces, nephews, X-spouses, business associates, close friends, a 10% or lower ownership in one of the above entities and apparently not in-laws.

**TAX ALERT 2:** If the non-recourse financing is from a third-party lender, who receives a fee with respect to the taxpayer’s investment in the property (or a related* person to such a lender), then the loan will not be considered at-risk and these loss limitations will come into play. IRC 49(a)(1)(D)(III); IRC 465 (b)(3).

**AA COMMENT:** Does this stupid provision mean this - if a lender (such as a mortgage broker) receives a fee, then the non-recourse loan is not considered at-risk? Or does it mean that the mortgage broker can receive a fee for placing the loan, but cannot receive a fee in respect to finding or arranging the “taxpayer’s investment in the property”? I interpret it to mean the latter. Assuming this, do the following strategies.

**STRATEGIES:**

1. Document that the fee is for the loan and not for finding or arranging the “taxpayer’s investment in the property”.

2. If feasible, transact with one of the above unrelated parties.

The at-risk limitations are covered in Goldmine Chapter 27, Part D.
To accurately compute the realized gain and resultant tax liabilities, use the computation format below which is followed by an explanation of each line item on the format. Included here are Goldmine Forms S-1 to S-5, including a case study with filled-in forms.

**Basic Format For Computing Realized Gain:**

1. Total Selling Price (see form S-2).................. +$___________
2. Less: Selling Expenses (see form S-3).......... - _____________
3. Equals: Net Selling Price............................. =$___________
4. Less: Adjusted Basis (see form S-4)............. - _____________
5. Equals: Gain..................................................... =$___________
7. Equals: Realized Gain...................................... =$___________
8. Times: Total Tax Rate (see form S-5)............ x _____________
9. Equals: Total Tax Liability (see form S-5)..... =$___________

**A Further Explanation of the Above Line Items Follows:**

**Line 1: Total Selling Price:** The total selling price (or the amount realized from the sale) includes cash received, the fair market value of any property received (such as a boat, car, etc.), seller financing and mortgages or liens
Line 2: Selling Expenses: These expenses reduce the total selling price and in turn reduce the realized gain (or increase a realized loss). Examples are transfer taxes, advertising, 1031 intermediary fees, legal fees, deed preparation, termite certifications and recording fees. Selling expenses also include seller assists and items that are obligations of the buyer (or that are customarily paid by the buyer) such as points, buydowns, transfer tax, title insurance, environmental studies, survey, etc. Included in this category would be any credits given by a seller in favor of a buyer. On disk, see form S-2 for a checklist of selling expenses.

Line 3: Net Selling Price: The total selling price (line 1) less selling expenses (line2).

[Note: For a 1031 tax-free exchange, the net selling price is also the minimum amount necessary that must be reinvested in replacement property to totally defer taxes in the 1031 exchange. For a further discussion, refer to Chapter 34.]

Line 4: Adjusted Basis: Basis is one of the initial steps in the computation of gain (or loss) and the resultant tax liability on any gain. (Section 9 contains a further discussion of basis). As time goes on, the original cost basis will change during the ownership of the property because of certain “plus-adjustments" such as capital improvements. Plus-adjustments increase basis and reduce the realized gain. On the other hand, there are “minus-adjustments" such as depreciation deductions. Minus-adjustments decrease basis and increase the realized gain. Thus, it is the "adjusted" cost basis that must be computed at the time of the disposition as follows:

1. Start: Original purchase price (or basis*)
2. Plus: Capitalized basis closing costs
3. Plus: Additional option payments
4. Plus: Capital improvements
5. Plus: Special assessments such as for sidewalks
6. Minus: Depreciation deductions allowed or allowable
7. Minus: Basis already allocated in previous partial sales
8. Minus: Deferred gains on prior tax-deferred rollovers
9. Minus: Cancellation of debt (Section 108)
10. Minus: Deductible casualty losses
11. Minus: Severance damages in condemnation proceedings

Equals: Adjusted Cost Basis

The above basis items are further explained:

**Start: Original purchase price (or basis*) -** This is the contract price from the original settlement sheet (HUD 1) or closing statement.

* Basis other than purchase: The above assumes the property was originally purchased by the owner. However, if the property was received in a different manner (such as inheritance or gift), other basis rules apply. For a further discussion, see Chapter 9.

**2. Plus: Capitalized basis closing costs** - These are closing costs to acquire or defend title to property such as title insurance, title fees, transfer tax, legal fees, recording fees, survey, etc. They are added to the property’s basis. See Section 10 for a further discussion.

**NOTE** Closing costs which are not included as part of basis are points, real estate taxes, interest, private mortgage insurance, hazard insurance. These types of closing costs are not added to the property basis, but instead have their own respective tax treatment. See Chapter 10 for a further discussion of buyer closing costs.
3. **Plus: Additional option payments** - If the purchaser had previously given an option payment to buy the property and the payment is not already included in the purchase price, then it becomes an addition to the property’s basis, upon exercise.

4. **Plus: Capital Improvements** - These are expenditures that are made subsequent to the acquisition of the property. They materially add value to the property, substantially prolong its life or change the property’s use. Capital improvements are added to the basis of the property and cannot be written off in the first year but are depreciated over a period of time by way of what are called statutory “recovery periods.” (See Chapter 12). On the other hand, "repairs" maintain the property in operating condition and are not added to basis. Instead, repairs are deductible as a property expense and therefore are not part of these computations. (Note: The distinction between capital improvements and repairs is not always clear-cut. See Chapter 17 for a further discussion.)

**TIP**: Double-check the tax basis of the property to see if you have included all capital improvements which add to basis and reduce taxable gain. For a checklist, see the back of special report I on homeowners exclusion on Renaissance Forms disk.

5. **Plus: Special assessments such as for sidewalks** - These are additional charges imposed by local government for improvements such as the installation of streets, sidewalks, sewers and other like improvements measured by some benefit that inures directly to the property against which the assessment is levied, Reg. 1.164-4(a). The cost of these types of assessments is not deductible, but instead added to the basis of the property, IRC 164(c)(1). See Chapter 23-B, Part B for a further discussion.

6. **Minus: Depreciation deductions allowed or allowable** - When the owner wants to dispose of their investment property, all depreciation allowed *(or that should have been allowed)* must reduce the basis of the property. This basis reduction has the same effect of adding back the depreciation to the realized gain.
This line item is simply a summation of the previous annual depreciation deductions taken by the property owner. See Chapter 12 for a further discussion of componentizing depreciation.

*ALERT*: Even if depreciation deductions were not taken by the property owner, they still must reduce basis and be added back to the realized gain.

**TIP**: Take depreciation deductions every year. However, if you missed taking depreciation, then get it back all in one year without having to file amended returns. You do this by filing IRS Form 3115 - *Application for Change in Accounting Method*. See Chapter 16 for a further discussion on how to do this.

7. Minus: Basis already allocated in previous partial sales - This is where part of the property was previously sold and part of the property’s basis was allocated to this previous sale. Reg. 1.61-6(a).

For example, you purchased a property for a total cost of $50,000 (including basis closing costs). You subsequently subdivide the property into two parcels, Parcel 1 and Parcel 2. You sell Parcel 1 and allocate $25,000 of the original basis to the sale of Parcel 1. You would have to reduce the original $50,000 basis by the $25,000 allocated toward the basis of the sale of Parcel 1.

**NOTE ON BASIS ALLOCATIONS**: The total basis must be “equitably” apportioned among the parcels, Reg. 1.61-6(a). (The same rule applies to condo conversations.) However, this equitable apportionment does not necessarily mean that the total cost basis must be allocated equally, as in the above example. This is especially so if the market values of the parcels differ because of location, size, view, etc. For example, assume that the total market value of the above property is $100,000, with $60,000 (60%) toward Parcel 1 and $40,000 (40%) toward Parcel 2. Based on this, the basis of Parcel 1 would be $30,000 (60% x $50,000). The remaining basis would then be $20,000 (40% x $50,000). (Also see IRS Publication 551.)
8. Minus: Deferred gains on prior tax-deferred rollovers - When a gain is not currently taxed because of a deferred rollover, the untaxed gain does not go away but stays with each rollover and would become taxable if the property were eventually sold in a taxable disposition. This is why the untaxed gain is called a "deferred gain". Any gain that is deferred because of a non-taxable rollover (such as a 1031 exchange) reduces the cost basis of the replacement property. This in turn increases the realized gain. The property being sold may have been a replacement property that deferred all or part of a gain in a prior 1031 exchange or another tax-deferred rollover such as:

(a) Rollover of Gain Pertaining To The Sale of a Principal Residence (former IRC 1034). This law only applied to principal residences and not to investment properties. But it is still possible that this property was once the owner's home and was later converted into its present status as a rental property. If the original home was a replacement residence that deferred any gain on a prior sale, then this deferred gain reduces the cost basis of this property and thus increases the realized gain. (If this were the case, then this property would typically be a single family home or owner-occupied duplex dwelling.)

[Note: On May 7, 1997, IRC 1034 was repealed. However, any Section 1034 deferred gains still continue to reduce a property’s basis and increase gain as per the above]

(b) Involuntary Conversion Due to a Casualty (Fire, Flood, etc.), or Government Condemnation (IRC 1033). Here, gain is realized from the insurance reimbursement for property destruction (such as fire, flood, etc.), or compensation from government condemnation. IRC 1033 applies to both personal-use and investment property and can defer taxes on gain if certain tests are met, including acquiring replacement property. If the property being sold was the replacement property that deferred any gain on a 1033 conversion, then the
deferred gain reduces the cost basis of this property and increases the realized gain. (For a further discussion of involuntary conversion, see IRS Pub. 544)

9. Minus: Cancellation of debt - Generally taxpayers must include in income the amount of debt cancellation, IRC 61(a)(12). However, if the taxpayer meets certain requirements, instead of including the canceled debt as income, they can reduce the basis of real depreciable property that they own. When the property is disposed of, then the taxpayer must report the canceled debt as ordinary income, not capital gain. IRC 108(c). (TIP: One planning strategy to avoid this is a 1031 exchange. For a further discussion of this strategy, refer to Section VIII-18 of *The 1031 Money Machine*.)

10. Minus: Deductible casualty losses - Under IRC 165, a casualty loss is the damage, destruction or loss of property resulting from an identifiable event that is sudden, unexpected, or unusual (such as a fire or flood). You must reduce the basis by any deductible casualty loss, not covered by insurance. (Note: Any capital improvements as a result of the casualty, increase basis as “capital improvements”, number 4 above.)

11. Minus: Severance damages in condemnation proceedings - Gain can be realized from the insurance reimbursement for property destruction (such as fire, flood, etc.), or compensation from government condemnation. Under IRC 1033 (*Involuntary Conversion*), you can defer taxes on gain if certain tests are met, including acquiring replacement property. When part of your property is condemned, you may also be paid severance damages to compensate you for any decrease in the value of the remaining property. Severance damages are not part of the proceeds from the condemnation and are therefore not part of the amount realized for the determination of gain. Instead, they are tax-deferred as the severance damages reduce the basis of the remaining property, RR 68-37. (For a further discussion of involuntary conversion, see IRS Publication 544.)
12. **Minus: Demolition losses prior to January 1, 1984** - Under current law if a building structure is totally demolished, the remaining basis of the building and the costs of demolition must be added to the basis of the non-depreciable land on which the building is situated, IRC 280B. However, prior to January 1, 1984, there was much more favorable treatment in that you could have written off the remaining building basis (plus demolition costs) as a full loss deduction. Any such pre-’84 write-offs should be accounted for as a reduction in the property’s basis. (For a further discussion of demolition losses, with planning strategies, see Chapter 14.)

**Equals: Adjusted Cost Basis** (line 4) - The result of adding and subtracting the above adjustments. On disk, see form S-4 for a checklist of basis adjustments.

**Line 6: Passive Loss Carryovers**: These are unused losses from passive loss limitations on rental property losses. Once the property is sold in an outright sale to an unrelated party, then these unused loses can be used to offset the gain. (For a further discussion of passive loss limits, with planning strategies, see Chapters 24 to 26.)

**Line 7: Realized Gain**: This is the difference between the net selling price (line 3) less the adjusted basis (line 4) less passive loss carryovers (line 6). The realized gain is the total maximum gain that can be incurred on the disposition of the property. Accordingly, the correctly computed tax on the realized gain is the maximum amount of taxes that would be due on the taxable disposition of the property (without planning).

**ALERT**: The mortgage balance or any other property debt does not reduce the realized gain. Thus, it is possible to have negative equity in a property, but still have a taxable gain

**Line 8\9: Total Tax Rate\Total Tax Liability**: The tax rate and the amount of tax liability will depend on how much of the recognized gain is long-term capital
or ordinary, as previously discussed and illustrated in this section, Chapters 29 and 30.

**ALERT:** Watch for multiple & hidden tax liabilities on gains! There can also be additional tax liabilities as follows:

**Additional taxes from an increase in AGI** - A recognized gain increases adjusted gross income (AGI) which increases the capital gain tax bracket. It also increases the amount of any social security includable in income. An increase in AGI could also cause additional tax liabilities from the elimination or reduction of the following tax benefits: Certain itemized deductions, casualty/theft losses, IRA deductions, personal exemptions, and the child care credit. Losing these benefits means paying more taxes.

**Alternative minimum tax (AMT) higher rates** - In theory the top capital gain rate presently is 15%, (was 20% prior to May 6, 2003) is the same for both regular income tax and AMT (which has rates of 26% and 28%). However, such a theory does not actually work out practically for many investors, because the 15% (or 20%) rate on some capital gains can be erased under the AMT as well. After certain amounts of income, the exemptions for AMT phase out. To the extent that these exemptions are lost because of recognized gains, the effective rate on the gain becomes the AMT rate of 26% (or 28%). A gain will also incur state income tax liabilities. The deduction for any such state taxes is not allowed to reduce AMT income. Accordingly, this adjustment can also trigger AMT which is discussed in Appendix F).

**State & local taxes** - Depending on what state or locale the taxpayer is in, a gain could also result in additional state or local tax liabilities.

**TOTAL RATE:** Because of these multiple tax liabilities, the *total tax rate* on recognized gains can be 25%, 30%, 35% or even higher! See Form S-5 on disk
for computing the total tax liability on the sale or disposition of investment real estate.

**TIP 1: Adjust the basis and gain for state or local taxes.** With some locales (such as PA.) the deductibility of rental\business losses (including depreciation) is limited. Consequently, all or part of depreciation deductions will not be used to reduce state or local income. Accordingly, any unused depreciation should not reduce the basis. The gain would then be lower for state or local purposes. Other special basis rules may also apply.

**TIP 2: Adjust the basis and gain for AMT.** Because you must use different depreciation methods, there generally will be lower depreciation deductions for AMT. Accordingly, there will be a higher basis and lower gain for AMT gain computations.

**OVERALL PLANNING STRATEGY:** The most powerful way to zero out all of the above taxes on the sale of an investment property is a *1031 Tax-Free Exchange* (Chapters 32 to 34). Other tax reduction strategies are also discussed in Chapter 31.

**FORM:** *Computation of Realized Gain & Resultant Tax Liabilities*

**- EXPLANATION & INSTRUCTIONS -**

**Background:** The four profit centers for a real estate investment are:

(1) Net cash flow from rentals (plus many other sources of property income)
(2) Tax savings (substantial with this publication)
(3) Equity accumulation from amortization on the mortgage (paid by tenants via rents)
(4) Equity accumulation from profits on selling the property.
Frequently, the largest of the four profit centers is the last one -- profits on selling the property, which is also the one where investors get “killed” the most with taxes because they do not plan in advance, before the end of the year!

**Purpose:** Accurately computing the realized gain and resultant tax liabilities is the very first important step in preventing or reducing the tax drain from selling the property. To enable the investor to accurately compute the realized gain and resultant tax liabilities so they can have the necessary information to do advanced tax planning to reduce, eliminate or defer the gain.

**How-to-use:** Review the enclosed case study on computing the realized gain and resultant tax liabilities. Also enclosed is a Tax Planning Reminder.

**Checklist:** Tax Reduction Strategies To Reduce, Defer or Eliminate The Gain On The Sale of Investment Real Estate. See Goldmine Chapter 31 for a further discussion of these strategies.

There is also an Installment Sale Computation Form, which is contained in Appendix D-2. In this appendix there is both a blank form and a filled-in one from Example 2 of Goldmine Chapter 35, which contains a further discussion of installment sale computations.

**COMPUTATION OF REALIZED GAIN - BLANK FORMS & CHECKLISTS**

**FORM S-1: Basic Format For Computing Realized Gain**

1. Total Selling Price (see form S-2)...................... $_____________  
2. Less: Selling Expenses (see form S-3)............. - _____________  
3. Equals: Net Selling Price............................... =$_____________  
4. Less: Adjusted Basis (see form S-4)............... - _____________  
5. Equals: Gain................................................. =$_____________  
7. Equals: Realized Gain....................................... = $_____________
8. Times: Total Tax Rate (see form S-5)............... x _________________
9. Equals: Total Tax Liability (see form S-5)....... = $_____________

**FORM S-2: Checklist of The Total Selling Price***

1. Initial cash downpayment (earnest money deposits)........ $_____________
2. Other cash, such as buyer’s own cash at the settlement...... +_____________
3. Cash from buyer’s borrowed funds (such as buyer’s mortgage) +_____________
4. Prior untaxed option payments received for right to buy.... +_____________
5. Mortgage debt that is assumed or taken subject to by the buyer (usually at face value).......................................................... +_____________
6. Other debts of the property assumed or paid by the buyer. (such as back taxes, past due interest, liens, etc.)............... +_____________
7. Face amount of two-party note/mortgage between buyer and seller (i.e. seller financing such as an installment obligation)... +_____________
8. Fair market value of third party obligations (such as US treasury bonds, IBM debentures, a note)............................... +_____________
9. Fair market value of property other than cash (such as a real estate, a car, a boat, jewels, etc.)................................. +_____________
10. Other.......................................................................... +_____________

= Total Selling Price.................................................................. = $_____________

*As a practical manner, the total selling price is usually stated in the agreement of sale.

**FORM S-3: Checklist of Selling Expenses**

1. Advertising & marketing costs.......................................... $_____________
2. Certifications - occupancy................................................. +_____________
3. Certification - roof .......................................................... +
4. Certification - termite ....................................................... +
5. Certification – other ......................................................... +
6. Conveyancing fees .......................................................... +
7. Commissions & selling bonuses ........................................ +
8. Deed/document preparation fees ........................................ +
9. Engineering fees ................................................................ +
10. Environmental studies ..................................................... +
11. Exchange intermediary fees ............................................. +
12. Express mail charges ....................................................... +
13. Lawyer fees ...................................................................... +
14. Notary/affidavit fees ........................................................ +
15. Other professional fees ..................................................... +
16. Pest inspection fees .......................................................... +
17. Property inspection fees .................................................... +
18. Recording fees .................................................................. +
19. Seller assists - buyer points ............................................... +
20. Seller assists - other buyer closing costs ......................... +
21. Seller credits off purchase price ...................................... +
22. Settlement or closing fee .................................................. +
23. Smoke detectors .............................................................. +
24. Survey fees ...................................................................... +
25. Title search or examination ............................................... +
26. Transfer taxes - city/county tax stamps ......................... +
27. Transfer taxes - state tax stamps ..................................... +
28. Transfer taxes - other ....................................................... +
29. Warranty costs ............................................................... +
30. Other selling expenses: ______________________________ +

Total Selling Expenses ...................................................... $ __________

**TIP:** Don’t forget to account for all “POC” items -- Selling expenses are generally indicated on settlement sheets either as a direct column item indicating that the item is included in the settlement computation totals, or an indirect margin
note ("POC") indicating that the item has already been paid before the settlement as “Paid Out Of Closing.” Accordingly, these “POC” items are not in the settlement sheet computations but should be considered in a tax analysis.

Moreover, whether direct or indirect, not all selling expenses may appear on a settlement sheet in any way at all. They may have been paid separately by check, cash or credit card and thus not accounted for by the settlement agent. Sellers should ascertain if there are any such undisclosed selling expenses which reduce realized gain. Look for checks or credit card charges payable to the following: Lenders, title companies, attorneys, accountants, real estate agents, exchange intermediary companies, the seller, escrow companies, contractors, local government authority and other services such as terminate, property inspection, environmental, survey, etc.

**FORM S-4: Checklist of Basis Adjustments**

1. Start: Original purchase price (or basis).............................. $_______________
2. Plus: Capitalized basis closing costs.............................. +_______________
3. Plus: Additional option payments................................. +_______________
4. Plus: Capital improvements........................................... +_______________
5. Plus: Special assessments such as for sidewalks............... +_______________
6. Minus: Depreciation deductions allowed or allowable........ - ______________
7. Minus: Basis already allocated in previous partial sales....... - ______________
8. Minus: Deferred gains on prior tax-deferred rollovers........ - ______________
9. Minus: Cancellation of debt (Section 108)........................ - ______________
10. Minus: Deductible casualty losses................................. - ______________
11. Minus: Severance damages in condemnation proceedings.... - ______________
12. Minus: Demolition losses prior to December 31, 1983......... - ______________
13. Plus/Minus: Other adjustments_______________________ +\-______________

Equals: Adjusted Cost Basis................................................ $_______________

**FORM S-5: Computation of Total Tax Liability**

1. Realized Gain (from line 7, form S-1).............................. $_______________

   Breakdown of above Realized Gain:
   1A. Ordinary gain - Recapture\other __________________ $_______________
   1B. Capital gain - Straight-line SL

14
1. The selling price of the property is $500,000; selling expenses are $50,000.

2. Originally paid $190,000 and incurred another $10,000 in (basis) closing costs for a total initial cost of $200,000.

3. Did capital improvements of 70,000.

4. Deducted a total of $100,000 depreciation, of which $20,000 is additional depreciation recapture and the remaining $80,000 straight-line.

5. Elected to reduce the basis property by a canceled debt of $40,000 under Sec.108(c).

   NOTE: Therefore total ordinary income (taxed at 40%) will be $60,000 ($20,000, recapture + 40,000, canceled debt). The straightline depreciation of $80,000 will be taxed at 25% and the remaining gain taxed at 20%
6. Deducted a total of $20,000 in casualty losses.

7. There was also a prior deferred gain of $60,000 on a prior 1031 rollover.

8. There are no loss carryovers to offset the gain.

9. Assume, the top federal tax brackets of 40% for the ordinary income portion, 25%, for the straight-line depreciation, 20% for the remaining capital gain and a 5% state tax rate.

10. The property is being sold for all cash. There is no seller financing or assumption of mortgages. Therefore it will not be necessary to use Form S-2 in this example as the total selling price is $500,000.

With this information, you can complete the other forms below.

**FORM S-1: Basic Format For Computing Realized Gain**

1. Total Selling Price. (see form S-2)....................... + $500,000
2. Less: Selling Expenses (see form S-3)............. - 50,000
3. Equals: Net Selling Price................................. =$ 450,000
4. Less: Adjusted Basis (see form S-4).............. - 50,000
5. Equals: Gain.................................................. =$ 400,000

7. Equals: Realized Gain.................................... =$ 400,000
8. Times: Total Tax Rate (see form S-5)......... x see form S-5

9. **Equals: Total Tax Liability** (see form S-5)... = $116,000

**FORM S-3: Checklist of Selling Expenses**

1. Advertising & marketing costs............................... $ 1,000
2. Certifications - occupancy......................................... + 200
3. Certifications - roof .................................................. + 200
4. Certifications - termite............................................. + 250
5. Certifications - other .................................................. + 0
6. Conveyancing fees.................................................. + 0
7. Commissions & selling bonuses.............................. + 30,000
8. Deed\document preparation fees.............................. + 150
9. Engineering fees.................................................... + 0
10. Environmental studies........................................................... + 1,000
11. Exchange intermediary fees................................................... + 2,000
12. Express mail charges............................................................. + 50
13. Lawyer fees........................................................................... + 3,000
14. Notary\ affidavit fees............................................................ + 50
15. Other professional fees.......................................................... + 500
16. Pest inspection fees............................................................... + 0
17. Property inspection fees........................................................ + 0
18. Recording fees........................................................................ + 0
19. Seller assists - buyer points................................................... + 0
20. Seller assists - other buyer closing costs............................... + 0
21. Seller credits off purchase price............................................ + 1,500
22. Settlement or closing fee....................................................... + 100
23. Smoke detectors.................................................................... + 0
24. Survey fees............................................................................ + 0
25. Title search or examination.................................................... + 0
26. Transfer taxes - city/county tax stamps.................................. + 5,000
27. Transfer taxes - state tax stamps............................................ + 5,000
29. Warranty costs..................................................................... + 0
30. Other selling expenses:____________________________          + 0_____

Total Selling Expenses.................................................................. $____________

---

**FORM S-4: Checklist of Basis Adjustments**

1. Start: Original purchase price (or basis)................................. $ 190,000
2. Plus: Capitalized basis closing costs................................. + 10,000
3. Plus: Additional option payments................................ + 0
4. Plus: Capital improvements................................................ + 70,000
5. Plus: Special assessments such as for sidewalks.............. + 0
6. Minus: Depreciation deductions allowed or allowable........ - 100,000
7. Minus: Basis already allocated in previous partial sales...... - 0
8. Minus: Deferred gains on prior tax-deferred rollovers....... - 60,000
9. Minus: Cancellation of debt............................................... - 40,000
10. Minus: Deductible casualty losses................................. - 20,000
11. Minus: Severance damages in condemnation proceedings... - 0_____

Equals: Adjusted Cost Basis................................................. $ 50,000

---

**FORM S-5: Computation of Total Tax Liability**

GAIN TAXES

17
1. Realized Gain (from line 7, form S-1)..... $400,000

   Breakdown of above Realized Gain:
   1A. Ordinary gain - Recapture $20,000; 108
       $40,000
   1B. Capital gain - Straight-line SL depn........
       80,000
   1C. Capital gain - Not straight-line SL depn
       260,000
   Total (should equal line 1).................... $400,000

2A. Tax liability - Ordinary gain........ (line 1A. x 40%*) $24,000
2B. Plus: Tax liability - Cap.gain (SL depn.)
    (line 1B. x 25% *) + 20,000
2C. Plus: Tax liability - Cap. gain (not SL depn.)
    (line 1C. x 20% *) + 52,000

3. Equals: Total Federal Tax Liability.... $96,000
4. Plus: Total State Tax Liability........
    (State rate_5_% x ln.1) + 20,000
5. Plus: Other Tax Liabilities (attach expl.).

6. Equals: Total Tax Liability................ $116,000**

   *This case study used the following rates for state and federal taxes – ordinary gain rate of 40% and capital gain rate of 20%.

   **TAX RESULT WITH ADVANCED PLANNING: The taxpayer did a totally tax-free 1031 exchange and deferred all of the above tax liabilities of $116,000! As a 10% down payment, $116,000 can empower to acquire another $1,160,000 worth of real estate which will appreciate in value. This how you get wealthy.

Reference source (return tab): – Chapter 29

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval
system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
A. BUYER DEFAULT

While seller financing has numerous advantages to the seller, one of the disadvantages is the potential for buyer default on the mortgage. However, while the possibility of buyer default is a potential disadvantage, it can turn into an advantage. If the seller has to foreclose, they can sell the property again. This could be after collecting a bunch of payments before the foreclosure.

B. TAX IMPACT -- IS USUALLY TAXABLE GAIN
Our focus here is on the tax aspects of repossession by the seller. This is the situation where: The seller held back financing; elected installment reporting under IRC 453; the buyer subsequently defaults on the loan and the seller repossesses the property. Under IRC 1038, upon buyer default, when a seller takes back a property, either because of partial or full satisfaction of the debt, the repossession generally results in taxable gain to the seller, even though the seller receives no cash. Again, it’s our old nemesis - phantom income. This may sound crazy, (and unfair), but it’s true. Moreover, there still can be taxable gain, whether you repossess the property through foreclosure, or otherwise, such as negotiating with the buyer-borrower to voluntarily deed the property back to you in lieu of foreclosure.

However, by getting the “asset” back you can be benefiting as per the discussion in Part A. This provision does provide some fairness in that it does the following: (1) Defers paying the tax on the property’s increase in value from the time of the original sale to the time of repossession and (2) It limits the amount of taxable gain to the amount of cash payments received before the repossession.

C. COMPUTATION OF GAIN AND BASIS ON REPOSSESSION

1. GAIN: First off, you cannot deduct a loss from repossession. The taxable gain is computed using the lower amount of:

(a) The amount of all payments received prior to the repossession, less any taxable income from the installment sale prior to the repossession, or
(b) The total realized gain from the original sale, less any taxable income from the installment sale prior to the repossession, less any other money paid by the seller in connection with the repossession (presumably legal and other costs of repossession).

2. BASIS: The basis of the repossession property is the basis (or balance) of the outstanding debt, plus the taxable gain on the repossession, plus the costs of repossession.

EXAMPLE 1: FP sells a property with the following data: Total selling price of $100,000, less selling expenses of $1,000, less adjusted basis of $39,000 = a realized gain (or gross profit) of $60,000. The gross profit ratio is 60% ($60,000/$100,000). Terms of sale: FP receives $5,000 down and holds $95,000 in seller financing. Using IRS Form 6252, FP elects the installment sale method of deferring gain under IRC 453.

Subsequently, after paying another $5,000 in principal (or a total of $10,000), the buyer defaults. The outstanding balance of the debt at this time is $90,000 ($95,000 less $5,000). FP forecloses and repossesses the property. Repo costs are $1,000. The amount of taxable gain FP had reported prior to the repossession is $6,000 or 60% (GP ratio) times the $10,000 payments received.

Using the above formula, FP’s gain is the lower of a. or b. below, as follows:

(a)  
1. The amount of all payments received prior to the repossession....$10,000  
2. Less: Any taxable income prior to the repossession.......................- 6,000  
3. = Tentative amount of gain.............................................................$  4,000

(b)  
1. The total realized gain (gross profit) from the original sale..........$60,000  
2. Less: Any taxable income prior to the repossession (above)......... - 6,000  
3. Less: Costs of repossession.............................................................. - 1,000  
4. = Tentative amount of gain...............................................................$53,000  
Taxable gain* is the lower of the above.............................................$ 4,000
3. **CHARACTER OF THE GAIN**: The regulations are unclear as to the character of the gain on repossession (capital or ordinary). The rules are complex and illogical. [Reg. 1.1038-1(d)]. Because the original gain reported with installment sale reporting was capital, then it would appear logical that the above gain should also be a capital gain.

**Computation of property basis on repossession:**

1. Basis of outstanding debt (balance)................................................$90,000
2. Add: Taxable gain on the repossession............................................ - 4,000
3. Add: Costs of repossession.............................................................. - 1,000
4. = Basis* of repossessed property.....................................................$95,000

*NOTE*: The above basis is used for reporting the gain or loss on resale and for depreciation deductions, if you decide to hold the property for rental.

4. **HOLDING PERIOD**: For purposes of long-term capital gain, the holding period of the repossessed property includes the period in which the seller held it prior to the original sale. However, the holding period does not include the time the property was held by the defaulting buyer, Reg. 1.1038-1(g)(3).

**COMMENT**: Despite this provision being purportedly fair, I still would not like paying tax on a phantom gain, especially when I have to go through the cost and effort of a repossession. Accordingly, some planning strategies follow.

**D. STRATEGIES**

**STRATEGY 1**: Avoid repossession by avoiding buyer default in the first place. Before selling the property, carefully check the credit/financial profile of the buyer; obtain as high of a down payment as possible; and make sure that the mortgage is “recourse” debt, where the buyer is personally liable.
If you do repossess the property and incur taxable gain, below are some planning recommendations to reduce the tax impact of the gain:

**STRATEGY 2:** Try to resell the property in the year you incurred the gain from repossession. *Reason:* The taxable gain from the repossession is added to the property’s basis. This additional basis adjustment is effectively an offset to the taxable gain, if the two transactions happen in the same tax year. Don’t forget to add the costs of repossession as part of the basis. This too will offset the gain.

**STRATEGY 3:** Fully deduct any repairs for property damage caused by the buyer\borrower. Defaulting borrowers often become angry and upset about being foreclosed on. To vent their frustrations, they will unnecessarily do damage to the property as a parting gesture. Effective negotiations (such as “paying” them to move) could stop this from happening. However, if it does happen, the costs to restore a property to its original condition are fully deductible repairs (See Chapter 18). Certain replacements, such as appliances, are depreciable over 5 years as per Chapter 12. If you have componentized the building, you can also write off any real or personal property components that have to be replaced. See Chapter 12C for a further discussion of component write-offs.

**STRATEGY 4:** Fully deduct any other property expenses and depreciation. Once you repossess the property, you are again the investment property owner, who will incur operating expenses until you can resell the property (if you want to resell). Such expenses as taxes, insurance, utilities, maintenance are all property deductions. Also, start to claim depreciation deductions all over again.

**TAX TIPS FOR STRATEGIES 3 AND 4:**

(a) Once you again own the property, you should report it as a “rental property” on the appropriate IRS rental and depreciation schedules of your tax
return. Report it as if its a newly acquired investment property. **Reason:** This is the schedule where you will deduct the above expenses in Strategies 3 and 4 above.

(b) Claim the above expenses (including depreciation), even if it is for a short holding period, until the property is resold. Also claim any costs of repossession, that were later paid after the year of repossession. Deduct the repo costs on the rental schedule under “Legal and other professional fees”.

(c) If the property is not actually rented, then *document* attempts to rent it by way of newspaper ads, “for rent” signs*, listing contracts, flyers, etc.(*Take a photo of the rent sign.*) For a further discussion, see Section 27 (hobby loss provisions).

(d) If the property is not actually rented, then make the following audit reduction statement behind the IRS rental property form:

*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). There is no rent income because the property was involved in a foreclosure repossession under IRC 1038 (plus, for any other 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.*

**STRATEGY 5:** Look for tax losses or deductions to reduce taxable gain. For example, any loser stocks or bonds that can be sold by the end of the year will generate capital losses which can be used to fully offset the capital gain from the repossession. (See Chapter 44.) A business loss, retirement plan contribution and many other deductions can do the same. (See Chapter 28.)
STRATEGY 6: Eliminate installment sale reporting (and repossession gain), altogether, with three tax planning techniques:

1. Use the self-directed IRA (SDIRA), instead of installment sale.

2. Use the 1031 tax-free exchange, instead of installment sale.

3. Combine the SDIRA with the 1031 tax-free exchange, instead of installment sale.

For a further discussion of these techniques, see Chapter 39-B.

For more information on repossessing property, refer to IRC 1038, Reg. 1.1038-1 and IRS Publication 544.

Reference source (return tab): – Chapter 9
1. RECOMPUTING THE GROSS PROFIT BECAUSE OF SUBSEQUENT PRICE ADJUSTMENTS

Sometimes during the holding of a mortgage, the buyer and seller agree to reduce the purchase price. Some reasons could be a change in market conditions or the property’s cash flow is less than what was projected. Whatever the reason, if such a price adjustment occurs, then both buyer and seller must make adjustments for tax purposes.

(1) Tax consequences to the seller: This entails recomputing a new gross profit ratio for the remaining payments, RR 72-570. The original gross profit is reduced by the price reduction, any taxable gain previously reported and any renegotiation expenses. The new contract price is also adjusted to be the original contract price less the price reduction and any principal payments previously collected. The seller will then use the new lower gross profit ratio for
any remaining payments. This effectively corrects the taxable gain. Note: The seller cannot file for a refund by amending any prior returns, IRC 108(e)(5).

**EXAMPLE 1**: Refer to Example 1 in Section 35, where there was a contract selling price of $100,000, a gross profit of $60,000 and a gross profit ratio of 60%. Suppose the seller and buyer negotiate to reduce the price from $100,000 to $90,000, or by $10,000. Assume that this adjustment occurs after the buyer has made $40,000 of principal payments (including the original $30,000 downpayment). Accordingly, the taxable gain that has been reported at this point is $24,000 (60% x $40,000). The seller pays $1,000 in fees to renegotiate the transaction.

The recomputed gross profit is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original gross profit</td>
<td>$60,000</td>
</tr>
<tr>
<td>Less: Price reduction</td>
<td>- 10,000</td>
</tr>
<tr>
<td>Less: Taxable gain previously reported</td>
<td>- 24,000</td>
</tr>
<tr>
<td>Less: Renegotiation expenses</td>
<td>- 1,000</td>
</tr>
<tr>
<td><strong>The recomputed gross profit</strong></td>
<td><strong>$25,000</strong></td>
</tr>
</tbody>
</table>

The recomputed contract price is determined as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original contract price</td>
<td>$100,000</td>
</tr>
<tr>
<td>Less: Price reduction</td>
<td>- 10,000</td>
</tr>
<tr>
<td>Less: Payments previously collected</td>
<td>- 40,000</td>
</tr>
<tr>
<td><strong>The recomputed contract price</strong></td>
<td><strong>$50,000</strong></td>
</tr>
</tbody>
</table>

2
The recomputed *gross profit ratio* is determined as follows:

Gross profit (recomputed) .................. $  25,000*

Divided by contract price (recomputed) $  50,000

=Gross profit ratio (recomputed) .......... 50%  
   (lower than the original 60%)

*The above gross profit of $25,000* will be reported over the remaining term of the note.

Proof of these computations:

New total price ($100,000 less $10,000).. $  90,000

Less: Payments previously collected..... -  40,000

Remaining future payments............... =$50,000

X The new GP ratio............................ x 50%

= Future taxable gain ...................... =$25,000* (which is the above new gross profit to be reported over the remaining term)

**ALERT**: If instead of reducing the price, the seller accepts an amount that is less than face value in *total* satisfaction of the installment note, then this is treated as a taxable disposition of the installment note, IRC 453B(a). The above computations are then not necessary as their has been a total disposition of the installment note along with the triggering of any remaining gain. For a further discussion of note sales and other note dispositions, see Section 38.

**(2) Tax consequences to the buyer**: The buyer must reduce their cost basis by the price adjustment, which in this case is $10,000. If the property is non-depreciable land, then no other basis adjustment is necessary. Otherwise for
depreciable property the buyer must reduce the depreciable components by the basis adjustment. To do this the buyer will use the same ratio used for the original allocations.

For example, assume the buyer originally used the following allocations: Personal property - 15%, land improvements - 10%, building - 70%, and land - 5%. The $10,000 price adjustment would reduce the basis of these components as follows: Personal property - $1,500, land improvements - $1,000, building - $7,000 and land - $500. All of these allocations equals a total of $10,000. If a component has already been fully written off (such as the 5-year personal property), then the buyer should just reduce another component, such as land improvements.

**TAX ALERT ON DISCHARGE OF DEBT**: The buyer can reduce the basis as illustrated above, provided that the installment note is held by the original seller of the property, IRC 108(e)(5)(C). However, sometimes sellers sell or otherwise dispose of the note to another party. In this case, the amount of any debt reduction is discharge of debt and taxable income to the buyer/borrower, (unless the borrower is insolvent), IRC 61(a)(12) and 108(e)(5)(C).

**TAX TIP**: A solvent buyer may be able to defer this income from discharge of debt under a “108(c) Exclusion”. See Appendix G for a further discussion.

**2. SALES WITH A CONTINGENT SELLING PRICE**

Sometimes the selling price of a property is based on certain future outcomes, such as a percentage of the net operating income of the property. (In real estate jargon this is called a “performance mortgage” or an “earn-out”.) Here, because there is no set selling price, there can be no set contract price, no set gross profit and therefore no gross profit ratio. Accordingly, taxable gain cannot be computed using the standard installment sale formula as discussed in Section 35.
However, IRS regulations do have a set of rules for dealing with these types of installment sales. Reg. 15A.453-1(c). These regs address three types of contingent sales:

(1) Where there is a stated maximum selling price.

(2) Where there is no stated maximum selling price, but the time over which payments will be received is determinable.

(3) Where there is neither a stated maximum selling price nor a definite payment term.

(1) Where there is a stated maximum selling price. Here, the stated maximum selling price will be used to determine the contract price, gross profit and gross profit ratio. If the stated maximum selling price is later reduced, then the gross profit ratio will be recomputed for payments subsequent to the year of change. An example of this scenario, as adopted from Reg. 15A.453-1(c)(2)(B), is as follows.

**EXAMPLE 2:** C owns a property with a basis (including selling expenses) of $300,000. The agreement specifies that the price will be based on 5% of annual gross receipts from the property with a stated maximum selling price of $2,100,000. On the property there is also an existing assumable mortgage of $100,000 which the buyer will assume. Accordingly, the contract price is $2,000,000 (2,100,000 total price less 100,000 mortgage assumed). C’s total gross profit is $1,800,000 (2,100,000 price less 300,000 basis). The gross profit ratio is 90% ($1,800,000 CP divided by $2,000,000 GP).

In the first year C receives $100,000 in principal payments. The first year’s taxable gain is therefore $90,000 or 90% x $100,000. If the stated maximum selling price is later reduced, then the gross profit ratio will be recomputed for payments subsequent to the year of change. See Part 1 of this section on how to recompute the gross profit because of price changes.

(2) Where there is no stated maximum selling price, but the time over which payments will be received is determinable. In this scenario, as each
principal payment is received (exclusive of interest), the basis is recovered tax-free ratably over the period during which payments are received. Any remaining principal amount is taxable gain. Examples from Reg. 15A.453-1(c)(3)(ii) follow.

EXAMPLE 3: A sells Blackacre to B for 10% of Blackacre’s gross yield for each of the 5 years. A’s basis in Blackacre is $5 million. Since the sales price is indefinite and the maximum selling price is not ascertainable from the terms of the agreement, the basis is recovered ratably over the period during which payments are received under the agreement. Assuming annual payments over 5 years, this means that the $5,000,000 total basis will be recovered at $1,000,000 per year ($5,000,000 divided by 5 years). Thus, assuming A receives the following annual payments (exclusive of interest), A will report the following:

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Principal Payment</th>
<th>Basis Recovered (Tax-free portion)</th>
<th>Taxable Gain Portion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1....</td>
<td>$1,300,000</td>
<td>$1,000,000</td>
<td>$300,000</td>
</tr>
<tr>
<td>2....</td>
<td>1,500,000</td>
<td>1,000,000</td>
<td>500,000</td>
</tr>
<tr>
<td>3....</td>
<td>1,400,000</td>
<td>1,000,000</td>
<td>400,000</td>
</tr>
<tr>
<td>4....</td>
<td>1,800,000</td>
<td>1,000,000</td>
<td>800,000</td>
</tr>
<tr>
<td>5....</td>
<td>2,100,000</td>
<td>1,000,000</td>
<td>1,100,000</td>
</tr>
<tr>
<td>Total</td>
<td>$5,000,000</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

EXAMPLE 4: Same facts as the above example, except that the payment in year 1 is $900,000 (instead of $1,300,000). Since this installment payment is less than the basis allocated to that year, the unrecovered basis of $100,000 is carried forward to year 2.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Principal Payment</th>
<th>Basis Recovered (Tax-free portion)</th>
<th>Taxable Gain Portion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1....</td>
<td>$ 900,000</td>
<td>$ 900,000</td>
<td>$0*</td>
</tr>
<tr>
<td>2....</td>
<td>1,500,000</td>
<td>1,100,000</td>
<td>400,000*</td>
</tr>
<tr>
<td>3....</td>
<td>1,400,000</td>
<td>1,000,000</td>
<td>400,000</td>
</tr>
<tr>
<td>4....</td>
<td>1,800,000</td>
<td>1,000,000</td>
<td>800,000</td>
</tr>
<tr>
<td>5....</td>
<td>2,100,000</td>
<td>1,000,000</td>
<td>1,100,000</td>
</tr>
</tbody>
</table>

*Note: Only the first two years are affected by the change in this example.

**Special Rule Where Contingent Selling Price Will Cause Distortion of Taxable Income:** Under special rules, the taxpayer may use an
alternate method of basis recovery if the taxpayer can demonstrate that the application of the normal basis recovery rule will substantially and inappropriately defer recovery of basis (and therefore accelerate taxable income). With this exception, the taxpayer may be able to further defer taxable income from an installment sale with a contingent selling price. For a further discussion of these complex rules, see Reg. 15A.453-1(c)(7).

(3) Where there is *neither* a stated maximum selling price *nor* a definite payment term.

Here, the regulations raise the question of whether a sale realistically has occurred or if payments received are in the nature of rent or royalty income. According to the regulations, “arrangements of this sort will be closely scrutinized”. If, taking into account all of the pertinent facts, including the nature of the property, the arrangement is determined to qualify as a sale, the taxpayer’s basis (including selling expenses) shall be recovered in equal annual increments over 15 years, beginning with the date of sale, For further details, see Reg. 15A.453-1(c)(4).

3. INSTALLMENT OBLIGATIONS IN EXCESS OF $5 MILLION DOLLARS

*Special Rule:* Here the taxpayer must pay the IRS a certain amount of interest on the deferred tax liability from installment sale reporting, IRC 453A(a). The computation of this interest is done under special rules per IRC 453A(c). The interest paid is deductible, IRC 453A(c)(5). For this provision to apply the amount of the installment note must exceed a face amount of $5,000,000, outstanding as of the end of the year of the sale, IRC 453A(b)(2).

This provision does *not* apply to the following:

a) Installment notes that are $5,000,000 or less.

b) The sales of personal-use property (such a primary or second home)

c) Business-use property used for farming, IRC 453A(b)(3).

It also does not apply to the sales of residential lots or timeshares, where the taxpayer has already elected to pay interest on the amount of the deferred taxes in these types of sales, IRC 453A(b)(4). For more information about this
provision (including the computation of the interest), refer to IRC 453A and IRS Publication 537.

4. INSTALLMENT SALE - THIRD PARTY GUARANTEES AND STANDBY LETTERS OF CREDIT

Generally the seller of real property will have their seller financing debt secured by a mortgage, land sale contract or deed of trust. The security interest will be on the property sold. However, there are times where a seller may not desire the return of the property upon default, but instead would want to be assured the entire sales price specified in the sales contact. The buyer too may prefer not to have the property as security for the loan.

It is in these situations where the seller (or buyer) looks to a different form of security, often in the form of some type of third party guarantee or escrow arrangement.

THIRD PARTY GUARANTEES AND STANDBY LETTERS OF CREDIT

If they are properly structured, these are the safest types of arrangements against the IRS attacks of constructive receipt or economic benefit.

A. Third Party Guaranty (Co-Signor): Under the Installment Sales Revision Act of 1980, a third party guaranty used as a security is not a taxable payment, IRC 453(f)(3); Reg. 15A.453-1(b)(3)(i).

EXAMPLE 5: Mr. “Shaky Buyer” is not too credit worthy, so his rich Uncle Harry endorses (co-signs) on the note which the seller accepts. This is a qualifying third party guarantee which will not constitute payments.
**TAX ALERT:** A direct third party obligation is still a payment. Thus, if in the above example, the seller took a direct note from Uncle Harry, such a note would be considered a payment, Reg. 15A.453-1(b)(3)(i). See Section 38.

**B. Standby Letter of Credit:** The regulations also include “standby letters of credit” as a qualifying third party guarantee not constituting a taxable payment in the year of sale. Reg. 15A.453-1(b)(3)(iii). The regs define a standby letter of credit as a “non-negotiable, non-transferable (except together with the evidence of debt which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of debt which is secured by the letters of credit.

**ALERT:** A letter of credit will be considered a constructive payment, if it may be drawn upon in the absence of default of payment of the underlying evidence of debt. That is, it may not be drawn for any reason except that of buyer default on the underlying note. Reg. 15A.453-1(b)(3)(iii) (Emphasis added)

A letter of credit actually says that if the recipient defaults on the seller loan, then the issuing bank will make good on the money. The letter of credit is issued upon the recipient’s credit rating, and accordingly, is very much like a demand note. Although widely used in the import-export business, letters of credit are used in other areas of the businesses world, including real estate. They are generally issued by commercial banks who charge fees for letters of credit.

**NOTE:** Thus, it would seem relatively easy for a taxpayer to borrow against an installment obligation secured by a standby letter of credit and, in effect, enjoy the fruits of full payment without tax (barring the rules for pledged installment notes as per Section 38).
REMINDER: However, in order to qualify, the letter of credit must act as security and not be a direct obligation with the financial institution, and may not be drawn for any reason except that of buyer default on the underlying note.

However, the selection of these particular types of security, especially certain escrow arrangements, may take us into the perilous grounds of “constructive receipt” or “economic benefit”, causing the entire gain to be triggered and fully taxed in the year of sale, or whenever certain unrestricted escrows are created.

Whether the latter will occur or not, will depend on the type of arrangements and the individual facts and circumstances, based principally on 1980 IRS regulations and prior case law. However, as it will be seen, there is a degree of uncertainty of when the doctrines of “constructive receipt” or “economic benefit” apply, or do not apply. The discussion of these types of secured arrangements will be broken down into three categories of such arrangements, followed by a discussion of each one:

(1) THIRD PARTY GUARANTEES AND STANDBY LETTERS OF CREDIT

(2) CASH* ESCROW ARRANGEMENTS WITH SUBSTANTIAL RESTRICTIONS

(3) CASH* ESCROW ARRANGEMENTS FORMED ONLY AS SECURITY AGAINST BUYER DEFAULT VS. CASH ESCROW ARRANGEMENTS FORMED MAINLY AS A SOURCE OF PAYMENT BASED ON THE PASSAGE OF TIME

(*Reminder: ”Cash” also indicates cash equivalents such as certificates of deposits. See Section 36 for a further discussion).
(1) THIRD PARTY GUARANTEES AND STAND-BY LETTERS OF CREDIT

If they are properly structured, these are the safest types of arrangements against the IRS attacks of constructive receipt or economic benefit.

A. Third Party Guaranty (Co-Signor): Under the Installment Sales Revision Act of 1980, a third party guaranty used as a security is not a taxable payment, IRC 453(f)(3); Reg. 15A.453-1(b)(3)(i).

EXAMPLE 5: Mr. “Shaky Buyer” is not too credit worthy, so his rich Uncle Harry endorses (co-signs) on the note which the seller accepts. This is a qualifying third party guarantee which will not constitute payments.

TAX ALERT: A direct third party obligation is still a payment. Thus, if in the above example, the seller took a direct note from Uncle Harry, such a note would be considered a payment, Reg. 15A.453-1(b)(3)(i). See Section 38.

B. Standby Letter of Credit: The regulations also include “standby letters of credit” as a qualifying third party guarantee not constituting a taxable payment in the year of sale. Reg. 15A.453-1(b)(3)(iii). The regulations define a standby letter of credit as a “non-negotiable, non-transferable (except together with the evidence of debt which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of debt which is secured by the letters of credit.

ALERT: A letter of credit will be considered a constructive payment, if it may be drawn upon in the absence of default of payment of the underlying evidence of debt. That is, it may not be drawn for any reason.
A letter of credit actually says that if the recipient defaults on the seller loan, then the issuing bank will make good on the money. The letter of credit is issued upon the recipient’s credit rating, and accordingly, is very much like a demand note. Although widely used in the import-export business, letters of credit are used in other areas of the businesses world, including real estate. They are generally issued by commercial banks who charge fees for letters of credit.

**NOTE**: Thus, it would seem relatively easy for a taxpayer to borrow against an installment obligation secured by a standby letter of credit and, in effect, enjoy the fruits of full payment without tax (barring the rules for pledged installment notes as per Section 38).

**REMINDER**: However, in order to qualify, the letter of credit must act as security and not be a direct obligation with the financial institution, and may not be drawn for any reason except that of buyer default on the underlying note.

(2) **CASH ESCROW ARRANGEMENTS WITH SUBSTANTIAL RESTRICTIONS**

Installment sale reporting has been allowed for cash escrow arrangements if such arrangements impose substantial and definite restrictions on the escrow funds. Revenue Ruling 79-91 further explains substantial restrictions as follows:

“For an escrow arrangement to impose a substantial restriction, it must serve a bona fide purpose of the purchaser, that is, a real and definite restriction placed on the seller or a specific economic benefit conferred on the purchaser.”
In one case installment sale reporting was allowed because of restrictions on the escrow funds, *Rebecca J. Murray*, 28 B.T.A 624 (1934) acq. In *Murray* over 50% of the purchase price was placed in escrow to be paid over a period of five years if the taxpayer did not enter into a competing business. Murray’s right to any unpaid installments from the escrow principal was subject to forfeiture if she breached her five year covenant not to compete in the same business with her purchaser. This was considered (and properly so) a substantial restriction with economic realty. See also, *Fred M. Stiles*, 69 TC 558 (1978).

**NOTE:** There may be situations where the seller makes certain covenants to the buyer and an escrow amount is set up to secure these covenants. Examples of such covenants may be an agreement to manage the property during the payout period, a guarantee of a certain rate of return, or the securing of a certain triple-A tenant.

Whether the aforementioned would be considered substantial restrictions enough to qualify escrows as part of installment sale reporting would remain to be seen. In fact, under the 1980 temporary regulations, even if an escrow arrangement has bona fide substantial restrictions, it is now uncertain if even these types of escrow arrangements would qualify for installment sale reporting. The reason is that these regulations questionably fail to distinguish unconditional escrow arrangements from escrow arrangements imposing substantial restrictions on the seller’s right to receive payments, Reg. 15A.453-1(b).

**CASH ESCROW ARRANGEMENTS FORMED ONLY AS SECURITY AGAINST BUYER DEFAULT VS. CASH ESCROW ARRANGEMENTS FORMED MAINLY AS A SOURCE OF PAYMENT BASED ON THE PASSAGE OF TIME.**

Whether an escrow arrangement is set up (a) only in the event of buyer default; or
(b) set up as a direct source of payment (regardless of buyer default) is not always clear, even in light of the form and wording of the sales agreements. There are two pre-1980 cases that illustrate where the courts drew upon the distinction between the latter types of escrows -- *C.J. Porterfield*, 73 TC 91 (1979) (taxpayer victory), and, *J. Earl Oden*, 56 TC 569 (1971) (taxpayer defeat).

In *Porterfield*, the court found that the escrow account was in reality used only to secure the seller against an installment default and not as a direct payment from the escrow account. Accordingly, installment sale reporting was permitted.

In *Oden*, the escrow agreement called for direct payments to the taxpayer only after an installment default, but in practice, the escrow principal was used as a source of direct payment to Oden. Accordingly, the parties knew and contemplated that as each certificate matured the principal amount would be, and in fact was, paid to the seller regardless of whether the buyer was in default or no. Therefore, installment sale was denied.

Pertaining to the latter two cases the court finally drew the distinction between the escrow which: (a) Secures a seller against an installment default and (b) One which serves as a source of payment. The court stated: “*We left the implication in Oden that payments in escrow which are indeed intended and regarded solely as security for promissory notes are not payments for Section 453 purposes.*”

On the other hand, if the payments out of escrow are solely a source of payment, then installment sale will not be allowed, Reg.15A.453-1(b)(5)(Ex.8); RR 73-451; RR 79-91.

However, in these pre-1980 cases the courts still have not been consistent. In two cases the taxpayers used escrow arrangements solely for the purpose of security against default on the note. Although, the facts and circumstances were virtually the same as *C.J. Porterfield*, the court found that the escrow accounts
were effectively payments in the year of sale and installment sale reporting was therefore denied. See *J.K. Griffith*, 73 TC 933 (1980) and *Everett Pozzi*, 49 TC 119, 1967.

The Temporary Regulations came out after 1980 and they failed to distinguish between escrows with substantial restrictions and those without. In addition, such regulations do not differentiate between escrow arrangements used only to secure against buyer default and those used solely as a source of payment based on the passage of time. Whether escrow arrangements that impose substantial restrictions, or escrow arrangements that are used mainly to secure against buyer default, will be allowed installment sale reporting, is not certain at this time.

Of course, it has always been thought that an escrow formed solely as a source of payment based on the passage of time would be considered a disguised escrow, and would not qualify for installment sale reporting. However, one case demonstrates that such escrow arrangements may be recognized and installment sale reporting allowed. This case is discussed below.

**REED**: Initially the Tax Court denied installment sale, where the buyer/borrower placed the full purchase price in escrow to be paid to the seller with the seller being entitled to the sum after the passage of a specified amount of time. The Tax Court said that the seller must recognize the full gain when the purchaser deposits the funds in escrow. However, the First Circuit has disagreed and reversed the Tax Court.

This court ruled that a purchase-sale contract requiring deferred payment of the purchase price through the use of an escrow arrangement is effective to shift income recognition to the year of actual receipt of the proceeds by the seller. That is, installment sale reporting will be recognized, if there is the following:
(a) The escrow arrangement is part of a bona fide arm’s-lengths agreement made before the closing between the purchaser and the seller calling for deferred payment.

(b) The seller receives no present beneficial interest of incidental benefits from the purchase funds while they are in escrow.

(c) The holder of the funds in escrow must be acting under the authority of both the seller and the purchaser or the purchaser alone.

In this case, provided that the above three conditions are met, neither the doctrine of constructive receipt or economic benefit requires the recognition of income by the seller until the funds are released from escrow. Reed vs. Comm’r, 83-2 U.S.T.C. 9738 (1st Cir. 1983), rev’g T.C. Memo.

**ALERT:** The Reed decision happened in the first circuit. Whether the IRS or courts from other circuits will recognize “Reed escrows” remains to be seen.

**BUT WATCH THIS:** In another unusual case the seller was given the option not to accept the buyer’s offer to pay the entire price in cash, but instead receive installment payments using an escrow arrangement, solely to defer the taxes via installment sale. Surprisingly, the court decided that a substantial restriction of the seller’s right to receive the sales proceeds did exist and installment sale reporting was allowed, *E. Grannemann*, DC Mo. 87-1 USTC 9287, 649 F. Supp. 949.

**ESCROW ARRANGEMENTS - STRATEGY RECAP:**

1. **Use a co-signor or letter of credit.** At the present time, the only type of secured arrangement that will safely not be denied installment sale reporting is a properly executed third party guarantee such as a co-signor or a letter of credit, discussed above.
2. **Have at least some type of substantial restrictions** (if you cannot do strategy 1). Examples of restrictions could be - an agreement to manage the property during the payout period, a guarantee of a certain rate of return, or the securing of a certain triple-A tenant. While there is authoritative support in the way of case law, the regulations will have to be more explicit about these types of arrangements. Until that time, the seller has at least some degree of risk of being denied installment sale reporting.

3. **A the very least, follow what Reed above did.** It has always been thought that such “disguised” escrows would not qualify for installment sale reporting. However, the Reed and Grannemann cases (cited above) do open some doors even in this area, although you could expect controversy. The following is a review of what Reed did:

   (a) The escrow arrangement is part of a bona fide arm’s-lengths agreement made before the closing between the purchaser and the seller calling for deferred payment.

   **TAX TIP:** Use arm’s length documents that comply with your state’s law.

   (b) The seller received no present beneficial interest of incidental benefits from the purchase funds while they are in escrow.

   **TIP:** The seller should not be entitled to interest on the escrow funds.

   (a) The holder of the funds in escrow must be acting under the authority of both the seller and the purchaser or the purchaser alone.

   **TIP:** There should legally binding documents evidencing this authority.

4. **Use alternative forms of security that will clearly not cause the disallowance of installment sale reporting.** Examples are a “blanket
mortgage” or “substitute collateral”. A blanket mortgage is one that encumbers two or more properties. Substitute collateral is where other collateral (usually real estate) is used to secure the buyer’s performance on the mortgage. Legal counsel should be sought.

**INVESTOR TIP:** Although some of the above arrangements do have some tax risk, the seller should still look to secure their position as much as possible.

5. **Eliminate installment sale altogether with three techniques:** (1) Use the Self Directed IRA (SDIRA), instead of installment sale; (2) Use the 1031 tax-free exchange, instead of installment sale and (3) Combine the SDIRA with the 1031 tax-free exchange, instead of installment sale. For a further discussion, see Chapter 39-B.

Reference source (return tab): – Chapter 36
## APPENDIX D-1: Installment Sale Computation Form

**Reference source:** Chapter 35

### A. Terms of Sale:

1. Seller takeback (installment sale; ___% ___ yrs.)
   
2. Plus: Buyer’s downpayment (cash or other prop.)
   
3. Plus: Existing debt assumed or taken subject to
   
4. = Total selling price

### B. Gross Profit:

5. Total selling price (line 4 above)
   
6. Less: Adjusted basis
   
7. Less: Selling expenses
   
8. = Realized gain
   
9. Less: Depreciation recapture (fully report as OI)
   
10. = Gross profit (for GP ratio)

### C. Contract Price:

11. Total selling price (line 4 above)
   
12. Less: Existing debt assumed or taken subject to
   
13. Plus: Excess-of-debt-over-basis
   
14. = Contract price

### D. Gross Profit Ratio:

15. Gross profit (line 10 above)
   
16. Divided by contract price (line 14 above)
   
17. = Gross profit ratio

### E. Payments Received (first year of sale):

18. Cash down payment
   
19. Plus: Market value of property other than cash
   
20. Plus: Principal pmts during the year
   
21. Plus: Excess-of-debt-over-basis (line 13 above)
   
22. Plus: Other payments (see Section 36)
   
23. = Total payments rec’d - year of sale

### F. Recognized (Taxable) Gain In Year of Sale:

24. Total payments rec’d - year of sale (line 23)
   
25. X Gross profit ratio (line 17 above)
**A. Terms of Sale:**
1. Seller takeback (installment sale; 9%, 30% 5 yrs.) $ 70,000
2. Plus: Buyer’s downpayment (cash or other prop.) + 30,000
3. Plus: Existing debt assumed or taken subject to + 0
4. = Total selling price............................... =$ 100,000

**B. Gross Profit:**
5. Total selling price (line 4 above)........................ $ 100,000
6. Less: Adjusted basis........................................ - 30,000
7. Less: Selling expenses........................................ - 10,000
8. = Realized gain............................................. = 60,000
9. Less: Depreciation recapture (fully report as OI) - 0
10. = Gross profit (for GP ratio)............................. =$ 60,000

**C. Contract Price:**
11. Total selling price (line 4 above)........................ $ 100,000
12. Less: Existing debt assumed or taken subject to - 0
13. Plus: Excess-of-debt-over-basis........................ + 0
14. = Contract price............................................... =$ 100,000

**D. Gross Profit Ratio:**
15. Gross profit (line 10 above)............................. $ 60,000
16. Divided by contract price (line 14 / 100,000 above)............
17. = Gross profit ratio........................................... = 60%

**E. Payments Received (first year of sale):**
18. Cash down payment........................................... + 30,000
19. Plus: Market value of property other than cash + 0
20. Plus: Principal pmts during the year............... + 478
21. Plus: Excess-of-debt-over-basis (line 13 above) + 0
22. Plus: Other payments (see Section 36)................. + 0
23. = Total payments rec’d - year of sale............... =$ 30,478
F. Recognized (Taxable) Gain In Year of Sale:
24. Total payments rec’d - year of sale (line 23)..... $ 30,478
25. X Gross profit ratio (line 17 above)................. X 60%
26. = Recognized (taxable) gain in year of sale..... $ 18,287

G. Recognized Gain In Years After Sale:
27. Total principal payments for the 2nd year........ $ 523
28. X Gross profit ratio (line 17 above)................. X 60%
29. = Recognized (taxable) gain for the year........ $ 314

Reference source: Chapter 35

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.
APPENDIX E: Investor Vs. Dealer - Further In-depth Research With Statement of Investment Intent

By: Albert Aiello, CPA, MST

CONTENTS

Reference source: Chapter 42

1. WILLIAM MALAT TO THE RESCUE!

2. FACTORS USED BY TAX COURTS TO DISTINGUISH INVESTORS VS. DEALERS

3. DISCUSSION AND ANALYSIS OF THE ABOVE FACTORS

4. SALES BY A JOINT VENTURE MADE UP OF DEALERS AND INVESTORS

5. SECTION 1237 RELIEF FOR LAND DEVELOPERS & SUBDIVIDERS

6. CONDO CONVERSIONS OF RENTAL UNITS INTO CONDOMINIUMS

7. SELL THE ENTIRE PROPERTY TO A SECOND INTERMEDIATE ENTITY TO SPLIT THE TOTAL GAIN INTO LT CAPITAL GAIN AND ORDINARY INCOME

8. STATEMENT OF INVESTMENT INTENT TO AVOID DEALER STATUS.

1. WILLIAM MALAT TO THE RESCUE!

In William Malat the Supreme Court further clarified IRC 1221(1) by stating that property is held “primarily” for sale to customers when that is the principal purpose. That is, when it is of “first importance” or “principally” (emphasis
added). Therefore ordinary income does not result even if a sales purpose is substantial, but not dominant, *William Malat v. Riddell*, 383 US 569 (1966). Thus, if the taxpayer can demonstrate that another 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 of law. As discussed in Section 42, *Malat* was a favorable decision for active real estate entrepreneurs.

**STRATEGY**: At the end of this appendix, use the “*Statement Of Investment Intent*”. Keep a notarized copy in your LLC minutes, partnership agreements, accounting records, correspondence, etc. Send a copy to your tax advisor, attorney and Realtor. This type of intent is a powerful defense against IRS attacks of being a dealer.

### 2. FACTORS USED BY TAX COURTS TO DISTINGUISH INVESTORS VS. DEALERS

However, despite *Malat*, the courts still have not provided enough guidance to help a taxpayer determine which factors are most important in the classification process. A comprehensive analysis on the topic is a study conducted to determine which facts are most important to Tax Court Judges in distinguishing the group of taxpayers receiving capital gain treatment (investors) from those taxpayer’s receiving ordinary income treatment (dealers) in real estate transactions. The study included over 100 Tax Court cases which were decided from 1960 through 1977. Overall, ten factors were determined to be significant in distinguishing capital gain from ordinary income - Factors: 1 to 5, 7, 8, 14, 15 & 17. See the list of these factors on the next page.

Four of these significant factors are called determinative because they are strongly related to the findings of the Tax Court. (Factor numbers 2, 3, 15 & 17.) These factors are identified in the list on the next page by a double asterisk**. These four determining factors are the most important of all the
factors.

The “corroborating” factors are not as significant as the determining ones, but they are useful for providing additional support for the taxpayer’s position (Numbers 1, 4, 5, 7, 8, & 14). These factors are identified in the list on the next page by a single asterisk*. Factors that are neither determinative nor corroborating are of limited use in classifying the taxpayer as an investor or a dealer, but nevertheless factors that still should be considered.

However, although some factors are more important than others, **no one factor by itself is determinative**. As many factors as possible (especially the significant ones) should be considered in determining investor or dealer status.

**Note:** In *Winthrop* the tax court restated many of these factors. [*Winthrop v. Tomlinson*, (CA-5) 69-2 USTC 9686, 417 F.2D 905].

### List of Factors Used By Tax Courts To Distinguish Investors vs. Dealers

<table>
<thead>
<tr>
<th>Factor</th>
<th>Determining</th>
<th>Corroborating</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Purpose for which the real estate was acquired</td>
<td>..................</td>
<td>..........*</td>
</tr>
<tr>
<td>2. Frequency, number, and continuity of sales</td>
<td>..........**</td>
<td></td>
</tr>
<tr>
<td>3. Time &amp; effort spent in buying and/or selling real estate</td>
<td>..........**</td>
<td></td>
</tr>
<tr>
<td>4. Extent of improvements made by the taxpayer</td>
<td>..................</td>
<td>..........*</td>
</tr>
<tr>
<td>5. Length of time the real estate was held</td>
<td>..................</td>
<td>..........*</td>
</tr>
<tr>
<td>6. Purpose for which the real estate was held</td>
<td></td>
<td></td>
</tr>
<tr>
<td>7. Comparison of taxpayer’s income from sale of</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

3
real estate to income from other sources.................. ...................*  

8. Extent, nature, & necessity of advertising to promote sales .................. ...................*  

9. Nature and extent of the taxpayer’s business  

10. Whether the taxpayer is licensed to sell real estate  

11. Extent of the taxpayer’s real estate holdings  

12. Volume of gross sales from the sale of real estate  

13. Whether taxpayer made continuing purchases of RE  

14. Use of sales personnel........................................... ......................... ...................*  

15. Whether investment property is distinguishable from other types of property taxpayer owns............. ........**  

16. Substantiality of gain  

17. Reason for selling the real estate......................... ........**  

Note: The above are not hard & fast tests that are necessarily controlling for deciding investor versus dealer status.  

3. DISCUSSION AND ANALYSIS OF THE ABOVE FACTORS  

First, each case must be decided upon its particular facts, and the presence of any one or more of these factors may or may not be determinative of a particular case, Los Angeles Extension Co. v. US, 315 F.2d 1 (9th circuit). Also, it is not the taxpayer’s characteristics, but rather the characteristics of the individual property transactions that are determinative, Harbour Properties,
Inc., 32 TC Memo 580 (1973). (Bold emphasis added) Of the above 17 factors only the more important ones will be further discussed as follows:

**Factor 1: Purpose for which the real estate was acquired**. Some courts take the position that the purpose for which the property was held at the time of sale determines whether a sale or exchange results in ordinary income or loss or in capital gain or loss, Owen v. Com., (1951, CA5) 192 F2d; Neely Taylor, TC Memo 1966-29; Robertson, TC Memo 1984-176. However, other courts disagree as to when this purpose should exist and for how long, McGah v. Com., (1952, CA9)193 F2d 662.

**STRATEGY**: Despite the disagreement of the courts, *investment intent* should be documented as early as possible. Sale of a well known land developer was allowed capital gain treatment because he *intended* to hold the property for capital appreciation at the time he purchased it, Hicks, TC Memo 1978-373. (Emphasis added). See Strategies 1 & 2 in Section 42 and *The Statement of Investment Intent* at the end of this appendix.

Property acquired with no intent to own it, such as through inheritance or bequest, has a better chance of being considered investor property, even if improvements have enhanced the salability of the property. A trust sold 17 parcels in one year. All of the properties were received as a gift, held for appreciation and inactively sold, Schwerin, Helen Trust, TC Memo 3/11/54, 13 TCM 202.

Although not recommended, having the pre-intent to sell, does not necessarily indicate dealer status. In one case a tract of land bought as an investment was sold to a group of homebuilders under an agreement that they would buy lots when and if improvements were made, Thrift, W. Sr., (1950) 15 TC 366(A).

Even an acquisition with the primary intent to resell may not produce ordinary income where it can be shown that the taxpayer is not in the business of “selling” real estate, Mitchell, 47 T.C. 120; also see Buono, (1980) 74 TC 187
Factor 2: Frequency, number, and continuity of sales**. The frequency & number of sales is one of the more important factors in the determination of an investor versus a dealer. At least one court has emphasized that frequent and substantial sales were more important factors than development activities or solicitation and advertising efforts, *Suburban Realty Co v. U.S.* 7/5/77, 80-1 USTC. However, the frequency and number of sales test does not necessarily cause the property owner to be a dealer especially if the elements of development and sales activity are lacking and especially if there are offers from unsolicited buyers, *Ralph J. Oace*, 39 TC 743 (1963); *Allen Moore*, 30 TC 1306 (1958).

Moreover, merely disposing of investment assets is not engaging in the business of a dealer, even though some preliminary effort is necessary to prepare the property for sale, *Fahs*, 161, F.2D 315 (1947).

There is inconsistency here. In one case the taxpayer was found to be a dealer even though he only made 7 sales, *Wibbelsman*, 12 TC 1022 (1949).

Yet, there are many cases involving numerous sales, where the taxpayers were found to be investors. The following frequent & continuing selling activities did not bar capital gain, even for “dealers”:

1) Taxpayer sold 95 subdivided lots in 2 years, *Fahs*, Ibid.

2) Taxpayer, a doctor, had 31 sales over a 2-year period, *Mathews v. Com.*, 315 F.2d 101.

3) A real estate dealer sold 19 rentals properties in one year and 27 in another year, *Farry* (1949) 13 TC 8(A).

5) Taxpayer sold 28 lots over a 7-year period, Williams, D.J. v. U.S. 3/1/83, DC-TX, 53 AFTR 2d 84-884, 84-1 USTC ¶ 9384.

6) A builder (“dealer”) sold 6 homes over a 2-year period, Sweeney, TC Memo 1964-324.


8) Taxpayer sold 10 lots a year over a 5-year period, Oace (1963) 39 TC 743.

9) Several hundred lots were sold, Tibbals, TC Memo 1958-44.

10) Taxpayer made unsolicited sales of 28 unimproved tracts to 15 individuals over a 3-year period, Brodnax, TC Memo 1970-164.

11) 67 subdivided lots sold individually over six years, Dressen (1952) 17 TC 1443(A).


For more about attaining investor status despite a larger number of sales, see the discussion on condo conversions, Part 6 of this appendix.

STRATEGY: The best defense for a large number of sales is Liquidation of Investment, discussed under Factor 17 in this appendix and in Section 42. This is what Farry [in (3) above] used to successfully attain investor status. Many others have done the same.

Factor 3: Time and effort spent in buying and/or selling real estate** Here if the property’s increase in value is not from intensive efforts to
sell or improve the property, then investor status could be argued, *Scheuber*, Ibid. This is especially so if the dealer was holding the property for “appreciation” over a period of time. [See *William Malat v. Riddell*, 383 US 569 (1966)]. This factor also relates to number 4, *Extent of improvements made by the taxpayer*, number 8, *Extent, nature, & necessity of advertising to promote sales* and somewhat to number 16, *Substantiality of gain*.

However, just because a property owner expects to make a profit from a price increase does not necessarily cause them to be a dealer, *Municipal Bond Corp*, 382 F2.d 184 (1967), rev’g 46 TC 219 (1966), on remand 341 F2d 683 (1965), rev’g 41 TC 20 (1963). Buying non-income property (such as land) with the expectation of profiting only from an increase in value may qualify as a form of investment entitling the taxpayer to capital gain on the sale, *Ronhovde*, TC Memo 1967-243. A joint venture engaged in speculation in hotel properties. It purchased hotels, held them for appreciation and then sold them at a profit, *Simberg*, TC Memo 1954-44. Investor status still can be attained even with the following: The taxpayer always intended that he would ultimately sell the property, the taxpayer was a licensed real estate broker and that the profit was large. What helps to support this is that there was no intensive effort to improve or sell the property and it was held for a substantial period of time, *Scheuber*, 371 F.2d, 996 (1967).

**Factor 4: Extent of improvements made by the taxpayer***. Here, the less improvements, the stronger argument for investor status. Investor status was attained when a railroad made 12 separate sales during two taxable years of unneeded parcels of land acquired for business reason. The property was only minimally improved, held several years and wasn’t advertised or promoted, *Toledo, Peoria & Western Railroad Co*, TC Memo 1976-366. Moreover, a reasonable amount of improvement may be made in order to dispose of realty at its true value without causing the owner to be considered a dealer, *Mundy*, 36 TC 703 (1961). Subdividing a property to enhance its value is not, per se, sales activity sufficient to classify the taxpayer as a dealer. This is so even if there was always an intent to sell the property, *Buono* (1980) 74 TC 187(A).
Subdivisions - Subdivided and improved property held for sale. Subdivision sales are very much related to this fourth factor. Unless a taxpayer comes within the special 5-year rule of Section 1237 (discussed later in this appendix), a taxpayer who actively subdivides property (with the exceptions described below) will generally be considered a dealer having held the property for sale to customers. A guideline followed by the courts is that reasonable expenditures for improvements to investment realty which is sold does not bar capital gain treatment and investor status. But as soon as the improvements exceed an amount which is in reasonable proportion to the original purchase price, for instance, when the improvements add up to a multiple of the original cost, the sales will result in ordinary income. Longfellow (1958) 31 TC 11; Hall, TC Memo 1956-135; Thompson (1962) 38 TC 153, affd (1963, CA5) 322 F2d 122; Sheater (1953, DC CA) 116 F Supp 230; Kelley (1960, CA9) 281 F2d 527.

The IRS ruled that a corporation realized ordinary (dealer) income from the sale of lots subdivided from land. It made sizable improvements in order to facilitate the sale of the lots. The improvements included grading and surfacing of streets and installation of drainage and utilities, RR 59-91. The business of building houses (to be sold) is also a substantial improvement, O’Donnell, (1959) 31 TC 1175.

IMPORTANT TAX BREAK: As per the bold emphasis all of the above cases were before the 1966 Malat Supreme Court case. Accordingly, the planning strategies in Section 42 (especially liquidation of investment) will be much more effective with Malat now on our side]

Moreover, as with other aspects of this issues, nothing is carved in stone as there are numerous cases where subdividers have been allowed investor status, such as where the taxpayer sold 95 subdivided lots in 2 years, Fahs, Ibid. Other cases are: Parmer, TC Memo 1971-320, affd on other grounds (1972, CA 10) 468 F2d 705, 30 AFTR 2d 72-5689, 72-2 USTC ¶ 9726; Reithmeyer (1956) 26
TAX POINTER: Generally, these cases had special circumstances, as do most cases of dealers being awarded investor status. Moreover, many of them were post Malat cases, indicating the present, more favorable attitude of the courts. See Section 42 for planning strategies.

**Factor 5: Length of time the real estate was held**. Holding a property for many years indicates an investment purpose, *Palos Verdes Corp.* (1952, CA9) 201 F2d 256, 43 AFTR 150, 53-1 USTC 9143. For an entrepreneur who has engaged in a substantial number of real estate transactions, the period of time held may be a critical factor in determining if they are a dealer or an investor. Holding property for many years indicates an intention to hold for investment rather than for sale as a dealer, *Austin*, 263, F2d 460 (1959). The sale of a well known land developer was allowed capital gain treatment because he held the property for 11 years as one of several factors in his favor, *Hicks*, TC Memo 1978-373. However, short holding periods do not necessarily mean dealer status. In *Peter R. Shibley* the tax court stated that a sale soon after completion of a property may receive investor treatment if the primary intent is to rent rather than sell (*30 TCM 597 9, 1971). Having the pre-intent to sell, does not necessarily indicate dealer status. In one case, a tract of land, purchased as an investment, was sold to a group of homebuilders under an agreement that they would buy lots when and if improvements were made, *Thrift, W. Sr.*, (1950) 15 TC 366(A). Moreover, just because you expect that the property will increase in value does not necessarily mean you are a dealer, Reg. 1.1031(a)-1(b).

**Factor 6: Purpose for which the real estate was held**. See factor 1 above and Chapter 42 for planning strategies.

**Factor 7: Comparison of taxpayer's income from sale of real estate**
to income from other sources*. If the taxpayer’s income from selling real estate is significant in comparison to other income, this could be an indicator of dealer status. It seems that a successful entrepreneur is being penalized by the comparison of income test, whereas a comparison of the time devoted by the investor may be more favorable. See Mathews v. Com., 315 F.2d 101. But this is only one factor. The others must also be considered.

**TAX TIP:** Try to realize sales income in years when you have other substantial income.

**Factor 8: Extent, nature, and necessity of advertising to promote sales*.** The less the taxpayer does of these types of sales activities, the more likely they will be considered an investor. A real estate developer attained investor status when he sold lots without solicitation, Pasadena Investment Co., (1963, DC TX) 223 F Supp 639, 12 AFTR 2d 5683, 63-2 USTC 9767. The sale of a well known land developer was allowed capital gain treatment because the taxpayer did not advertise or list the property; the sale was initiated by the buyer, Hicks, TC Memo 1978-373.

This factor relates to the *reluctancy of sale test* that came out of the Supreme Court case, William Malat, Ibid. A documented reluctance to sell can help to support investor status. Such reluctance is demonstrated by not soliciting offers to sell or advertise the property and entering the sale with at least some reluctance, Municipal Bond Corp, 382 F2d 184 (1967), rev’g 46 TC 219 (1966), on remand 341 F2d 683 (1965), revg 41 TC 20 (1963). Property owned by a dealer can be investment property if it is held for a substantial period of time with no or minimal efforts to sell the property, Cashvan, 272 F. Supp. 765 (E.D. VA. 1967). (See also Malat)

Other cases where reluctance of sale lead to investor status: Taxpayer sold 28 lots over a 7-year period. He didn’t solicit offers for the lots and didn’t negotiate. He merely accepted or rejected offers that came in, without having improved the property or having advertised it for sale, Williams, D.J. v. U.S.
Rental properties held for a long period were liquidated in large numbers in a seller’s market with a marked absence of business-like sale promotion or solicitation of purchasers, *Goldberg v. Com*, (1955, CA5) 223 F2d 709; *Ross v. Com*, (1955, CA5) 227 F2d 265. Taxpayer made unsolicited sales of 28 unimproved tracts to 15 individuals over a 3-year period, *Brodnax*, TC Memo 1970-164. Many rented residences were sold either because of unsolicited offers to purchase by tenants and others, or because of pressure put on taxpayer by banks that had loaned them money, *Ferguson*, TC Memo 3/21/50, 9 TCM 243. See also *Martin v. U.S.*, (1954, DC GA) 119 F Supp 468, 45 AFTR 734, 54-1 USTC ¶ 9157.

However, a reasonable amount of sales activities is expected and does not necessarily cause one to be a dealer. Some activities, which may under certain conditions be seen as selling activities, are considered activities to protect and enhance the taxpayer’s investment. *Biedenharn Realty Company Inc. vs. U.S.*, 526 F2d 409, Revg 509 F2d 171. In another case the court held that the taxpayer does not lose investor status merely because they disposed of the land in the most advantageous manner, *Barker v. US*, 9/30/65, DC-CA, 16 AFTR 2d 6035, 65-2 USTC ¶ 9736.

**Factor 9: Nature and extent of the taxpayer’s business.** This factor is neither determining nor corroborating and relates to factors 3 and 4 previously discussed.

**Factor 10: Whether the taxpayer is licensed to sell real estate.** If the taxpayer is engaged in a business or profession other than real estate and does not hold a broker’s license, it is a strong factor in his favor, *Camp*, 226 F.2d 931 (1955). However, while there arguably can be some connection, for the most part a “dealer” in real estate is *different* than a “licensed real estate agent”. A dealer buys and sells property for their *own* account. The purpose of the dealer is to sell the property as quickly as possible for a profit on their *own* property. On the other hand, a real estate agent is involved in transactions that include
properties that (generally) are owned by others. As a middleman*, they represent a buyer or seller with the purpose of bringing the buyer and seller together to consummate a real estate transaction for a commission or fee. [See *Buono, (1980) 74 TC 187 (A) and Williford, TC Memo 1992-430]. Moreover, this factor is neither determining or corroborating and certainly not the only one.

**Factor 11: Extent of the taxpayer’s real estate holdings.** This factor is neither determining nor corroborating and relates to factor 15, discussed later.

**Factor 12: Volume of gross sales from the sale of real estate.** This factor is neither determining nor corroborating and relates to factor 7 previously discussed.

**Factor 13: Whether taxpayer made continuing purchases of real estate.** This factor is neither determining nor corroborating and relates to factor 15, discussed later.

**Factor 14: Use of sales personnel*.** There are cases to support investor status, where large real estate holdings were liquidated through independent real estate brokers, *Camp*, Ibid; *Smith*, 224 F. 2d, 353 (1955). Sixty seven (67) subdivided lots purchased for an investment were retained passively for 15 years and sold individually over six years through an independent salesman, *Dressen*, (1952) 17 TC 1443(A). The taxpayers had acquired properties for investment and gave a real estate broker complete control and supervision over the property with authority to develop it by subdivision. *Glienke v. US*, 8/17/64 DC-IL, 14 AFTR 2d 5555, 64-2 USTC 9762.

**STRATEGY:** For this planning strategy to be most effective, the relationship between the investor and broker should be as independent as possible, using arm’s length agreements.

**Factor 15: Whether investment property is distinguishable from**
other types of property taxpayer owns** (“Dual Status”). A taxpayer may be a dealer with respect to some property transactions and an investor with respect to other property transactions, *Maddux Construction Co.* (1970) 54 TC 1278; *Scheuber*, 371 F.2d, 996 (1967); *Turner* (1976 CA4) 540 F2d 1249. However, the dealer properties being sold should be separated from the ones being held for long-term investment or rental. *Alert*: If they are not, even the investor property may be considered dealer property upon its disposition. A real estate developer (a real dealer) attained investor status when he sold lots within a larger tract.

He considered the lots unsuitable for residential use at the start and recorded them in a separate investment account, *Pasadena Investment Co.*, (1963, DC TX) 223 F Supp 639, 12 AFTR 2d 5683, 63-2 USTC 9767. In another case the taxpayer did *not* separate his properties and was considered a dealer on *all* of his properties, *Walsh*, TC Memo 1994-295. (Underlined emphasis added)

**STRATEGY:** The clearest way to accomplish this is to use *separate entities*. See Goldmine Chapter 43.

**Factor 16: Substantially of gain.** This relates to the Supreme Court decision in *William Malat*, Ibid concerning the *amount of gain test*. Here if the property’s increase in value is not from intensive efforts to sell or improve the property, then investor status could be argued, *Scheuber*, Ibid. This is especially so if the dealer was holding the property for “appreciation” over a period of time.

However, just because a property owner expects to make a profit from a price increase does not necessarily cause them to be a dealer, *Municipal Bond Corp*, Ibid. Moreover, this factor is neither determining nor corroborating and certainly not the only one. For a further discussion, see Factor 3, *Time & effort spent in buying and/or selling real estate.*

**Factor 17: Reason for selling the real estate** (or changed
circumstances). This factor will lead us into *liquidation of investment* (liquidating reasons). As a determining factor, this is one of the most generally applicable tests that the courts will use. Here, a non-dealer or dealer’s investment intent is evidenced by some “changed intention” motivated by unanticipated events beyond the control of the taxpayer. Thus, even where entrepreneurs purchase property with the original intent to sell to customers in the ordinary course of business and there were extensive selling activities, they can still be awarded capital gain treatment. They can do so provided that they can prove that, because of certain “liquidating factors” beyond their control, they were “forced” or “pressured” to sell or exchange and liquidate their investments. That is, a dealer’s investment intent is evidenced by some “changed intention” motivated by unanticipated events beyond the control of the taxpayer. Also referred to as the doctrine of “commercial frustration”, this theory maintains this premise - why should the owner be penalized with the “dealer taint” because of factors beyond their control. It can be a powerful defense and has been successful in numerous tax court cases involving “investor-vs-dealer” controversies. In these cases, the liquidating factors and reasons (in bold) that contributed to the taxpayer’s success were as follows:

(1) **Pressure from creditors, and lacked expertise or means to develop property.** *Lomas & Nettleton Financial Corp.* (180, DC Tax) 488 F. In another case investor status was attained where the taxpayer sold 67 subdivided lots over six years in order to **pay debts**, *Dressen*, (1952) 17 TC 1443(A). (Emphasis added)


(3) **Abandoned development plans, too costly.** *Lowery*, TC Memo 1964-30; *Edwards Industries*, TC Memo, 1974-120.

(4) **Abandonment of condominium development project in a forced bulk sale and termination of the joint venture,** *Silversmith v US*, 12/5/78, 79-1
USTC 9117.

(5) Abandoned real estate business to go into other full time employment. 

(6) Disagreement with Co-owners. *Flose, Jr.*, TC Memo 1973-98


(8) Special or changed market conditions. *Pontchartrain Park Homes, Inc.* 349 F2d, 416, affg TC Memo 1963. This is one that could be used frequently because the real estate market could be subject to changes. In one case the taxpayer was a partnership engaged in developing tracts of real estate for sale to customers. They also built 194 duplexes for rental. When it was determined that there was a poor rental market, the taxpayer actively sold the duplexes. The Ninth Circuit reversed the tax court’s decision and allowed investor status, because the property was disposed of as a “liquidation” of an investment. This was so even though the evidence supporting the taxpayer’s contention that the sale was for liquidating purposes was less than overwhelming. Such evidence was nevertheless sufficient to afford the taxpayer capital gain treatment, *Heller Trust*, 382, F.2d 675 (1967). (Notice that this is a post 1966- *Malat* case.)

Investor status was allowed in the sale by a real estate dealer of 19 rentals properties in one year and 27 in another year because of **rent control and high prices.** *Farry* Ibid.

In another case the taxpayer was in the business of constructing houses for sale. When the sales market disappeared, the taxpayer rented the houses in an attempt to salvage a return until they could be sold at a profit. The Tax Court, citing *Malat* as requiring a determination of the “primary purpose” for which the property was held, treated the sale as the liquidation of an investment, *Scottwood Development Co.*, 26 TC Memo, 855 (1967) {Post ’66).
NOTE: In *Scottwood* the taxpayer proved *Malat* as the IRS could not establish that the taxpayer’s chief purpose was to sell to customers in the ordinary course of business.

A builder had sold 6 homes over a 2-year period. He had built these homes to hold as rental units and sold them only because **market conditions were more favorable for sale than rental**, *Sweeney*, TC Memo 1964-324. See also *Dillon v. Com.* 213 F.2d, 218 for changed conditions requiring “liquidation”.

Most of several hundred lots were disposed of in bulk in what was virtually a single sale at a price considerably **below the price** obtainable by selling the lots separately, *Tibbals*, TC Memo 1958-44. (Bold emphasis added in the above cases)

**9) Unsuitable for particular purpose(s), making it impractical to proceed.** *Est. Dean*, TC Memo 1975-137. In another case a real estate developer sold lots within a larger tract where he considered the lots unsuitable for residential use at the start, *Pasadena Investment Co.*, (1963, DC TX) 223 F Supp 639, 12 AFTR 2d 5683, 63-2 USTC 9767.

**10) Financially unable to continue as planned.** *Dahlstrom*, TC Memo 1968-197. In another case the taxpayer made land sales which were forced by unexpected financial reverses to sell its business, *Jersey Land and Development Corp v. US*, 3/21/75, DC-NJ, 35 AFTR 2d 75-1157, 75-1 USTC 9386.

**11) Poor health.** *Lowery*, TC Memo 1964-30. In another case, the taxpayer had to sell because they were in ill health and anxious to set their business interests in order, *Pasadena Golf Course Inc.* TC Memo 1975-237. Thus, sudden ill health could cause a developer to retire from business. Because of this external event beyond the control of the taxpayer, investor capital gain would probably be permitted, despite the fact that dealer (developer) property is being sold.

(13) **Death of major principal.** *Simmers & Son, Inc.*, TC Memo 1968-150.(Don’t rush this one!)

(14) **Building or zoning restrictions.** Property acquired for building as rental investment was sold in a number of separate sales because the sales were forced by building restrictions, *Lobello v. Dunlap*, (1954, CA5) 210 F2d 465, 45 AFTR 337, 54-1 USTC ¶ 9234. When zoning restrictions prevented construction of a proposed hotel, unimproved real property was sold in 12 parcels. *Edwards, P.*, TC Memo 9/10/53, 12 TCM 1045.

(15) **Property acquired by inheritance.** *John R. Hopkins*, 15 T.C. 160. Property acquired with no intent to own it, such as through inheritance or bequest, has a better chance of being investor property, even if improvements enhance the salability of the property. A trust sold 17 parcels in one year. All of the properties were received as a gift, held for appreciation and inactively sold, *Schwerin, Helen Trust*, TC Memo 3/11/54, 13 TCM 202.

(16) **Condemnation or threat of condemnation.** Property admittedly held for sale to customers can receive capital gain treatment where there is a condemnation or threat of condemnation*. *Tri-S Corp*, 68-2 USTC 9541; *Ridgewood Land Co. Inc* TC Memo 1972-16, *Fabiani*, TC Memo 1973-203; *Biedermann*, (1977) 68 TC1.

* **STRATEGY:** Use Involuntary Conversion (IRC 1033) to defer taxes on the gain - Here, gain is realized from compensation from government condemnation. This provision (IRC 1033) can defer taxes on gain if certain tests are met, including the need to acquire replacement property. See Section 31 and IRS Publication 544 for a further discussion.

(17) **Property disposed of through foreclosure.** The tax law says that a gain
(or loss) is recognized on the sale or “disposition” of a property [IRC 1001]. A regular sale of property is not the only type of “disposition” and is therefore not the only way to incur a gain. Another type of disposition that could result in a gain is the foreclosure of a property. The sales price (or “amount realized”) would be the amount of debt relieved. If the debt relieved exceeds the tax basis of the property, then there is a taxable gain. However, unlike most normal sales, where there is cash to be received, a foreclosure disposition results in an old nemesis, *phantom income*, which is *non*-cash income, but is still taxable. In the following cases the taxpayer’s gain on the foreclosure was taxed as capital gain and not ordinary income, *Penman*, 4/9/57, DC-FL, 52 AFTR 1686, 57-1 USTC; *Ayling*, (1959) 32 TC 704(A); *Loewenberg*, TC Memo 10/11/48, 7 TCM 702; *Lloyd v US*, 6/12/61 DC-WA, 8 AFTR 2d 5586.

**Other.** And any other similar types of circumstances that are beyond the control of the taxpayer. For example, partners in business of managing real estate for the production of income, sold certain real estate in order to raise cash to cover losses in an unrelated business, *Martin v. U.S.*., (1954, DC GA) 119 F Supp 468, 45 AFTR 734, 54-1 USTC ¶ 9157.

**Recap of the Liquidation Of Investment Theory:** In short, capital gain treatment and investor status might be available where the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continued pre-existing use of the realty. The court stated that “…Acts of God, condemnation of part of one’s property, new and unfavorable zoning regulations, or other events forcing alteration of taxpayer’s plans create situations making possible subdivision and improvement as part of capital gains disposition.” The court cautioned, however, that although it might permit an owner substantial sales flexibility where there is a forced change from original investment purpose, it won’t absolutely shield a taxpayer from ordinary income. A taxpayer isn’t granted carte blanche to undertake intensely all aspects of a full-blown real estate business. *Biedenharn Realty Company Inc.* vs. U.S., Ibid.
Recap of the Liquidation Of Investment Theory: In short, capital gain treatment and investor status might be available where the change from investment holding to sales activity results from unanticipated, externally induced factors which make impossible the continued pre-existing use of the realty. The court stated that “…Acts of God, condemnation of part of one’s property, new and unfavorable zoning regulations, or other events forcing alteration of taxpayer’s plans create situations making possible subdivision and improvement as part of capital gains disposition.” The court cautioned, however, that although it might permit an owner substantial sales flexibility where there is a forced change from original investment purpose, it won’t absolutely shield a taxpayer from ordinary income. A taxpayer isn’t granted carte blanche to undertake intensely all aspects of a full-blown real estate business. Biedenharn Realty Company Inc. vs. U.S., Ibid.

IMPORTANT: The liquidating reasons should be clearly demonstrated in all documents such as LLC operating agreements, minutes, correspondence, etc. Failure to do so could result in dealer status as the burden of proof is on the taxpayer, Ferguson, TC Memo 1987-257.

TAX ALERT: The liquidation of investment defense loses its effectiveness if the investor subsequently acquires just flips, not keepers and does not reinvest the proceeds of the liquidation (at least in part) into the keepers*.

*STRATEGY: In this situation, to increase the effectiveness of the liquidation of investment defense avoiding dealer status, the entrepreneur should be into long-term keepers in the same LLC entity as the flips (documented by the statement of investment) as per Chapter 6.

4. SALES BY A JOINT VENTURE MADE UP OF DEALERS AND INVESTORS
In a joint venture or partnership situation, a *dealer* co-venturer does not necessarily taint a *investor* co-venturer as a dealer. In two related cases the Ninth Circuit held that the participants retain their own status, so that the dealer has ordinary income and the non-dealer has capital gain, *Margolis v. Com*, (1964, CA9) 337 F2d 1001. Similarly, the Tax Court has held that participation in a syndicate by investors and dealers did not bar capital gain treatment for the investors, *Cary*, TC Memo 1973-197. A partnership sold realty not as a dealer, although a 50% partner was individually a dealer, *Blackburn v. Phinney*, 7/31/61, DC-TX, 8 AFTR 2d 5220, 61-2 USTC ¶ 9599. The fact that the taxpayer’s partner in the joint venture was a real estate dealer did not cause the transaction to lose investor status, *Terry*, TC Memo 1984-442. Also remember, it is not the taxpayer’s characteristics, but rather the characteristics of the *individual property transactions* that are determinative, *Harbour Properties, Inc.*, 32 TC Memo 580 (1973).

5. SECTION 1237 RELIEF FOR LAND DEVELOPERS & SUBDIVIDERS

IRC 1237 allows non-corporate taxpayers to sell real estate from a single tract held for investment without the income being treated as ordinary merely because of subdividing the tract, or of active efforts to sell it, Reg. 1.237-1(a)(1). Under this provision, even extensive sales actives such as advertising, promotion, the use of sales personnel and other such activities will not, by themselves, cause the taxpayer to be considered a dealer, Reg. 1.1237-1(a)(2), 1.1237-1(a)(3). But this relief provision does not apply if the taxpayer is otherwise a “dealer” in real estate under the general guidelines pertaining to dealers, IRC 1237(a)(1).

The basic requirements to qualify under Section 1237 are:
(1) The taxpayer must *not* be a dealer
(2) The taxpayer cannot make any improvements to the property which will substantially increase its value.
(3) The tract must have been held by the taxpayer for five years (except if the property was acquired by inheritance, then there is no required holding period)
(4) The taxpayer must *not* be a corporation.

The first requirement zeros in on “dealer” status. This relief provision is not applicable, if the tract or any lot in the tract is, or has been held by the taxpayer primarily for sale to customers in the ordinary course of business. This also applies to all prior years. It also applies if, in the year of sale of the lots, the taxpayer also holds other real property primarily for sale to customers in the ordinary course of business.

As far as the second requirement, whether improvements substantially increase value is a question of fact. The regulations do state that improvements are not substantial within the meaning of IRC 1237(a)(2) if they are necessary to make the lot marketable at the prevailing local price, Reg. 1.1237(c)(1). Also, the increase in value to be considered must be from the improvements, themselves and not from other changes, such as market conditions, Reg. 1.1237(c)(3)(i).

One safe harbor that the regulations provide is that if the improvements increase the value of a lot by 10% or less, they are not substantial. However, this is not to be construed as a mechanical test as the regulations also state, “all relevant factors must be considered to determine, whether, under certain circumstances, the increase is substantial”, Reg. 1.1237(c)(3)(ii). Also, the improvement itself must be substantial in character. Among the improvements considered substantial are: shopping centers, other commercial or residential buildings, the installation of hard surface roads and utilities such as sewers, water, gas or electric lines. On the other hand the following are not substantial improvements: a field office, surveying, filling, draining, leveling, clearing and all-weather access roads, 1.1237(c)(4). However, if the taxpayer has held the property for
10 years, then certain site improvements (water, sewer, drainage facilities, roads, hard surface roads, curbs and gutters) are *not* substantial improvements, 1.1237(c)(5)(i).

**TAX REPORTING STRATEGY:** If you qualify for Section 1237 and use it, then make this statement behind the tax reporting schedules for the sale of the properties, “*Sales of property are capital gain per Internal Revenue Code Section 1237*”.

**ALERT:** Section 1237 does *not* apply to condo conversions and the sale of the condominiums to the general public, RR 80-216. This is discussed next.

For further details, see IRC 1237 and the corresponding Regulation 1.1237-1.

**COMMENT:** At first glance Section 1237 may appear to be a safe-harbor provision for dealers subdividing & selling lots. However, the first requirement above (no *dealer* status) makes it clear that dealers will not qualify for this so-called relief provision. Moreover, the second requirement above ("improvements") adds to the limitation on the usefulness of Section 1237. Overall, Section 1237 is essentially going to be limited to a noncorporate "investor", who can prove that they are not a dealer and who does not do the extensive improvements, mentioned above. The end result is that Section 1237 does very little to relieve the investor from proving investor status*.

* **STRATEGY:** Even if the taxpayer does not qualify under Section 1237, it still may be determined that the taxpayer is not a dealer as per the guidelines discussed in this appendix and Chapter 42. In most cases, taxpayers will have to!

**6. CONDO CONVERSIONS OF RENTAL UNITS INTO CONDOMINIUMS**
Some owners of apartment and office building convert their building into condominiums and then sell the apartments or offices as condos. Are the profits on the condo-unit sales taxable as capital gain from the liquidation of investment property (apartment or office building), or as ordinary income because the owner has gone into the business of selling units? The answer is the usual inconsistency with this issue as the IRS has not issued specific guidelines clarifying this area.

(1) **Those who probably say no to capital gain?** According to the House Ways & Means Committee, the sale of condominiums units by a property owner *generally* does not qualify for capital gain treatment. *House Ways and Means Committee Report 98-432, Part 2 on H.R. 4170, 3/5/84, p. 1703.* (Emphasis on *generally* to indicate the uncertainty here which is in the investor’s favor, especially with planning). Section 1237 (discussed above), which allows qualifying noncorporate taxpayers to report a capital gain on the sale of subdivided real property, does *not* apply to condo conversions and the sale of condominiums to the general public, RR 80-216. (Note: If you read my comment under Section 1237 this is no big loss anyway).

(2) **Those who say maybe to capital gain?** IRS Revenue Ruling 80-216 does not prevent a taxpayer selling condominiums units from qualifying for capital gain treatment. IRS has privately ruled that although Revenue Ruling 80-216 prevents condo converters using Code Sec. 1237 to qualify for capital gain treatment, it does not preclude a taxpayer from qualifying for capital gains treatment under some other Code Section [PLR’s 8212001* and 8204031]. However, *PLR 8212001 does not say under what circumstances a sale of condominium units can qualify for capital gain treatment.

(3) **Those who say yes to capital gain.** The Tax Court has allowed capital gain treatment on the sale of condo units to different buyers. The condos were sold as the last step in the liquidation of the taxpayer’s investment** in the rental apartment building, *Gangi*, TC Memo 1987-561. (**Gangi employed the powerful Liquidation of investment defense, previously discussed in Chapter 19**
and will again be discussed in this chapter, targeted to condo conversions.)

In his book, *Federal Income Taxation Of Real Estate*, foremost real estate tax expert, Gerald Robinson, says this when discussing passive loss activities, but related to condo conversions: “If property previously held for rental becomes property held for sale to customers, so-called dealer property, how is gain or loss on the sale treated? Suppose, for example, that a residential apartment complex is converted to condominiums and the condominiums are sold. Is income from the sale passive income? In general, the Regulations provide that if the property sold was predominantly in a nondealing activity and was not acquired for sale, it will be treated as having been used in the preceding nondealing activity. Thus, in the example, it would be treated as used in a real estate rental activity, so the gain would be passive activity gross income, Temp. Reg. 1.469-2T(c)(2)(v).” See also Reg. 1.469-2(c)(2)(v). In other words, the regulations, when addressing passive loss activities, effectively admits “property held for sale to customers” could be treated as non-dealer property, including condo conversions.

**ALBERT AIELLO STORY – TWO ACTUAL IRS AUDITS**

**First IRS Audit:** When I was studying for my Masters in Taxation degree, I attended the program with a number of IRS agents. One was Charles (“Chick”) Carman, CPA, MST who was a field (or revenue) agent at the time. Chick eventually was promoted to the appeals division, but has since left IRS to do teaching and private consulting. He’s highly competent. At that time he was handling a case involving the conversion of about 140 apartments that were individually condominiumized, sold and reported as investor capital gain. With this number of sales, Chick, representing the IRS, argued for dealer status (ordinary income). This went on for quite a while. Every week, Chick would keep me informed. Finally, Chick would not give in and it went to the appeals division, where, LO & Behold, the taxpayer won! Yes, they were awarded capital gain\investor status after selling 140 condos!! From what I could gather, their best weapon was the *Liquidation of investment*
Second IRS Audit: In this same tax program there was professor Bill McGarvey, CPA, formerly with Price Waterhouse and a real estate developer. Bill represented someone who sold 60 converted condos in Atlantic City, NJ. and reported the sales as investor capital gain. They argued the Liquidation of Investment and won at the examination level, without even having to go up to appeals.

Because they never reached the tax court, these scenarios are not documented as tax court cases. However, they did happen and demonstrate that there is viable planning to avoid being a dealer even with larger condo conversions.

7. SELL THE ENTIRE PROPERTY TO A SECOND INTERMEDIATE ENTITY TO SPLIT THE TOTAL GAIN INTO LT CAPITAL GAIN AND ORDINARY INCOME

With condo conversions, another strategy to at least partially reduce taxes is to sell the entire property to a second intermediate entity to split the total gain into long-term capital gain and ordinary income. Here, you at least avoid being totally taxed at higher ordinary income rates. This technique is appropriate for condo conversions and larger land subdivisions and where the property has been held for the required long-term capital gain period, (which is presently one and one day or longer). It involves two transactions. In the first transaction the taxpayer sells the entire property, as a whole at its present fair market value to a second separate entity*, preferably an LLC. The investor will generally have some controlling interest in this intermediate entity. Because it is one sale of a long-term asset, the gain on this sale is treated as long-term capital gain, taxed at lower rates. The intermediate entity picks up a higher basis at the appreciated purchase price of the property. The entity then develops, improves, subdivides and prepares the property for sale by advertising, using sales agents, etc. In the
second transaction the entity sells the completed, subdivided units to customers in the ordinary course of business. Presumably, because the units are subdivided and completed, the entity receives a higher price for the units than the purchase price of the entire property in the first transaction. As a dealer, the entity reports the gain as ordinary income. However, there is an advantage in that the ordinary gain will be lower because of the higher basis as discussed above. But this strategy has several pitfalls: (1) It’s complex to do and calls for astute planning. (2) It does not totally save you in taxes and in fact could still involve substantial tax liabilities. (3) It still could be challenged by the IRS and possibly totally fail as a tax-reduction strategy. (4) The aforementioned discussed strategies are no riskier and even may be safer, yet could save much more in taxes (even all) on the condo sales. (5) It only works where the property to be converted to condos has been held (or will be held) for the long-term capital gain period of one year and one day and there are no related party issues with IRC 1239. Accordingly, this sell-to-an-intermediate-entity technique will not be discussed here.

8. STATEMENT OF INVESTMENT INTENT TO AVOID DEALER STATUS WITH ONE INVESTMENT ENTITY

The One LLC-Partnership Is An Investment Entity of Rental Keepers and Resale Flippers

This LLC-partnership of investment keepers and resale properties (flippers) is your Investment Entity with the primary purpose of long-term investment continuity via The Statement of Investment Intent.

This intent is supported by the fact that the resale properties are ancillary to the operation of this investment entity in that the sole purpose of the resale property profits is to ensure the existence of the long-term investment keepers.

Accordingly, the flips are non-dealer sales resulting in investment profits. Moreover, properties that the LLC purchases are a continued investment of the properties that are sold.
The end result is that the keepers and resale properties are fused together to become one integrated economic investment unit. Consequently, the profits of all sales (short or long term) are investment income, not dealer income.

See the Statement of Investment Intent, next.

**STATEMENT OF INVESTMENT INTENT TO AVOID DEALER STATUS**

Document investment intent by incorporating below the fully documented Statement of Investment Intent in all of your records. Include a notarized copy of the Statement Of Investment Intent as part of the “Purpose” of your partnership agreement or LLC operating agreement. Include it in your LLC minutes. Send a copy to your tax advisor, attorney and Realtor. Attach it to your tax return.

**Statement Of Investment Intent**

*As per the Supreme Court Case, William Malat (383 US 569), for all properties that I acquire it is my primary intent to keep the property for investment/rental purposes along with long-term capital appreciation. I will only the sell the property if my original and primary investment intent is changed by unanticipated events generally beyond my control. Examples of such events are:*


*Financially unable to continue as planned.* [Dahlstrom, TC Memo 1968-197; Jersey Land and Development Corp v. US, 3/21/75, DC-NJ, 35 AFTR 2d 75-1157, 75-1 USTC ].

*Special or changed market conditions.* [Pontchartrain Park Homes, Inc. 349 F2d, 416, affg TC Memo 1963.; Heller Trust, 382, F.2d 675 (1967); Scottwood Development Co., 26 TC Memo, 855 (1967); Sweeney, TC Memo 1964-324; Dillon v. Com. 213 F.2d, 218; Tibbals, TC Memo 1958-44; Farry 13 TC 8(A)].


**Pressure from creditors.** [Lomas & Nettleton Financial Corp. (180, DC Tax) 488 F. Dressen, (1952) 17 TC 1443(A).]

**Disagreement with Co-owners.** [Flose, Jr., TC Memo 1973-98]

**New investment plans.** [Maddux Construction Co. (1970) 54 TC 1278]

**Unsuitable for particular purpose(s), making it impractical to proceed.** [Est. Dean, TC Memo 1975-137; Pasadena Investment Co., (1963, DC TX) 223 F Supp 639, 12 AFTR 2d 5683, 63-2 USTC 9767.]

**Building or zoning restrictions.** [Lobello v. Dunlap, (1954, CA5) 210 F2d 465, 45 AFTR 337, 54-1 USTC ¶ 9234; Edwards, P., TC Memo 9/10/53, 12 TCM 1045]

**Disaster such as fire or flood.** [Tri-S Corp, 68-2 USTC 9541; Ridgewood Land Co. Inc. TC Memo 1972-16; Fabiani, TC Memo 1973-203; Biedermann, (1977) 68 TC1]

**Abandonment of investment plans, too costly.** [Lowery, TC Memo 1964-30; Edwards Industries, TC Memo, 1974-120.]

**Abandonment of real estate to go into other full time employment.** [Vaughn, TC Memo, 5/14/48.]

**Abandonment in a forced bulk sale and termination of the joint venture,** [Silversmith v US, 12/5/78, 79-1 USTC 9117]

**Property disposed of through foreclosure.** [Penman, 4/9/57, DC-FL, 52 AFTR 1686, 57-1 USTC; Ayling, (1959) 32 TC 704(A); Loewenberg, TC Memo 10/11/48, 7 TCM 702; Lloyd v US, 6/12/61 DC-WA, 8 AFTR 2d 5586]


Property acquired by inheritance or gift. [John R. Hopkins, 15 T.C. 160. Schwerin, Helen Trust, TC Memo 3/11/54, 13 TCM 202]

Poor health. [Lowery, TC Memo 1964-30; Pasadena Golf Course Inc. TC Memo 1975-237]

Death of major principal [Simmers & Son, Inc., TC Memo 1968-150]

Respectfully and truthfully submitted:____________________________________________________________

Notarized

Statement Of Investment Intent To Avoid Dealer Status
(continued)

As per the Supreme Court Case, William Malat (383 US 569), this intent is further supported in that the resale properties are ancillary to the operation of my investment entity whereas the sole purpose of the resale property profits is not for sales speculation but instead to ensure the existence of the long-term investment keepers. More specifically the profits from resales are for the following investment necessities:

1. A “general working capital fund” for property investment operations including preventive maintenance.

2. An “emergency working-capital fund” for a property emergency, such as an unexpected large repair or extended vacancy.

3. A reserve for the periodic replacement of property components.

4. To upgrade the keepers. Modernize them for more market appeal. Consequently, attract higher-quality residents for even higher rents and long-term investment value.

5. To add additional facilities such as storage units, parking, laundry equipment, or tenant optional upgrades for more income further increasing investment value.

6. To pay down debt, especially high interest debt. My investment entity can end
up owning properties with little or no debt in a shorter time enhancing investment value.

7. To invest in more properties for long-term investment and wealth accumulation.

8. To make paper investments such as discounted mortgages, tax lien certificates, structured settlements all long-term investment and wealth accumulation.

The overall purpose is that the keepers and resale properties are fused together to become one integrated economic investment unit.

Respectfully and truthfully submitted: __________________________

Notarized

NOTE: Put this statement in your LLC operating agreement and minutes, sign it and notarize it.

<table>
<thead>
<tr>
<th>Keepers</th>
</tr>
</thead>
<tbody>
<tr>
<td>[</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Flippers</th>
</tr>
</thead>
</table>

= One Integrated Economic Investment Unit

Here, there is economic substance in that the flips generate quick profits, not for sales speculation, but for investment necessities. That is, tax followed economics as opposed to tax avoidance motivation. Accordingly, as employed here, these flips are non-dealer, investment transactions with solid economic foundation.

Reference source: Chapter 42
1. WHAT IS AMT?

Our tax system is a two-tier system in the sense that it requires the computations of two separate tax liabilities (1) The computation of a regular income tax, and (2) The computation of the Alternative Minimum Tax (AMT). Of the two, you pay the higher tax. The purpose of AMT is to reduce the benefit of certain tax “loopholes”, known in AMT parlance as “preferences” or “adjustments”. The AMT rates are 26% or 28%. The highest rate for regular income tax is 39.6% or 40% rounded. (From January 1, 2003, and scheduled to expire December 31, 2010, the top income tax bracket is 35%). AMT can be an unexpected tax trap for all taxpayers, including real estate entrepreneurs. The following is an overview of a rather complex topic.

2. THE BASIC AMT FORMULA

1. **Start:** Regular taxable income (from page 2 or your 1040).
2. **Add:** AMT *deduction* adjustments (these are certain *deductions* that are allowed in reducing regular income taxes, but are either partially or totally disallowed for AMT)
3. **Add:** AMT income adjustments (these are certain income items that are excludable from regular income taxes, but includable for AMT purposes)

4. **Equals:** Alternative Minimum Taxable Income (AMTI)

5. **Deduct:** AMT exemption (the exemption amt. depends on your filing status, see form 6251)

6. **Equals:** AMT base

7. **Multiply by AMT rate:** 26 or 28% (depending on the amount of the above AMT base)

8. **Equals:** Total AMT tax liability

9. **Less:** Total Regular income tax liability

10. **Equals:** Excess AMT tax liability (only if this amt. is positive; otherwise there is no AMT)

The following preferences or adjustments are added in calculating AMT. In other words, these items are subject to AMT.

**A. Deduction Items (Part or all of these deductions are not allowed for AMT):**

1. Personal exemptions for you, your spouse and dependents (a nasty one!)

2. The standard deduction (allowed in lieu of taking itemized deductions on Schedule A).

3. Certain itemized deductions on Schedule A (medical expenses, taxes, misc. expenses)

4. Interest on home equity debt (unless the loan funds are used to buy, build or improve a first or second home).

5. A certain amount of depreciation* on personal and real property (differences are small).

6. A certain amount of passive activity rental losses (differences are minimal at best).

7. A certain amount of net operating losses (NOL’s) (differences are minimal at best). NO MORE

8. Intangible drilling costs
9. Depletion (not “depreciation”) (Depletion pertains to oil wells)

10. Other unusual deductions, such as mining & development costs, research & experimental costs, pollution control facility amortization.

[*Depreciation - Generally, the depreciation used for regular income tax purposes will be computed differently than depreciation used for AMT purposes. For personal property, using the accelerated method, the depreciation deduction for regular income taxes is computed using the 200% (double) declining balance method. For AMT the 150% declining balance method is used, switching to the straight-line method in the year when a larger depreciation deduction results. First year expensing of personal property (IRC 179) is fully deductible for AMT as well and is therefore not an AMT adjustment. Real property depreciation uses a 40 year recovery period for AMT purposes.]*

**TAX POINTER:** Items 4 to 7 above will generally pertain to real estate. Items 5 to 7 are generally not that significant.

**B. Income Items (These income items are taxable for AMT purpose):**

1. Income from the exercise of incentive stock options (ISO’s).
2. Tax-exempt interest from private activity bonds (many tax exempts do not come under this category and are therefore not subject to AMT taxes)
3. Income from long-term contracts computed under the percentage-of-completion method.
4. Gain on small business stock qualifying for a 50% exclusion.

**3. STRATEGIES TO REDUCE OR AVOID AMT IMPACT**

Our planning strategies will fall into two main categories:

**I. TO COMPLETELY AVOID AMT, or**

**II. TO REDUCE THE IMPACT OF AMT**

**I. STRATEGIES TO COMPLETELY AVOID AMT**
1. Minimize taxable income -- As per the above AMT formula, the starting point for the computation of AMT is taxable income. Therefore, the lower your taxable income the better chances of avoiding AMT altogether. This technique is not: (1) Making less money, and (2) Is not illegally hiding income. Instead, minimization of income is employing certain legal tax strategies to exclude or defer income, such as the following.

- Postponing salary, bonuses or business income to a later year
- Deferring income via retirement plans
- Deferring income via a 1031 exchange
- Deferring income via Section 453 installment sale reporting (seller financing)
- The $250,000/$500,00 exclusions for homeowners
- There are also the Renaissance Goldmine componentizing deductions that reduce taxable income.
- And other income tax-reduction strategies in this publication.

2. If practical, avoid a large preference item that would cause AMT in the first place. For example, interest on home-equity debt is a preference item (unless the loan funds are used to buy, build or improve a first or second home). Here, you could find other sources of capital such as a credit line, signature loan, equity partners, your own capital, etc. Other preference items that you may try to avoid are income from the exercise of incentive options and tax-exempt interest from private activity bonds.

II. STRATEGIES TO MINIMIZE THE IMPACT OF AMT

Unlike Part I above, these strategies assume that you already are in an AMT situation (Damage control).

1. Try to avoid a large preference item in a year that you will be subject to AMT. For example, interest on home equity debt is a preference item (unless the loan funds are used to buy, build or improve a first or second home). Therefore try not to refinance your home in an AMT year. Other preference items that you may try to avoid are income from the exercise of incentive options and tax-exempt interest from private activity bonds.
2. Here, when you already are in an AMT situation, do the opposite as opposed to when you are avoiding it altogether as just discussed. Accelerate income into the current year. Here, you can take prepayments of salaries and bonuses, redeem bank CD’s, make early sales of investments, receive advance rents, convert tax-free municipals into taxable investments, etc.

3. Postpone deductions to the following year.

**NOTE**: The reason for doing 2 above (accelerating income), is because the present highest AMT rate is 28% versus 35-40% for regular income tax purposes. By accelerating income into the current year you will presumably take advantage of the lower AMT rate in the current year for such income. On the other hand, by postponing deductions into future years (3 above), you will presumably take advantage of the higher regular tax rate in the future year for such postponed deductions.

Again, the above assumes that the taxpayer is already in an AMT situation. Otherwise, employ the above total AMT avoidance strategies in the first part of this appendix.

**AMT TAX CREDIT**: In certain situations there could be an AMT tax credit from the regular income tax. Refer to IRS Form 8801 or seek competent tax counsel.

4. **MORE INFORMATION ABOUT AMT\FUTURE LEGISLATION**

Refer to Internal Revenue Code Sections 53, 55, 56, 57 and 58. Also, refer to the instructions for the AMT tax reporting form, IRS Form 6251. Author, *John Reed*, has developed an excel program to perform complex AMT computations. John is a superb author of many excellent real estate publications. For more information, call (925) 820-6292. Also, seek competent tax counsel.
Presently, there is talk in congress (and among tax practitioners) to either eliminate AMT, or to substantially change it where it better favors the taxpayer. Good idea!

Reference source: SAP 33
These are strategies that you can employ as late as December to reduce your taxes for the current year. The types of strategies you will employ will differ, depending on which of these two scenarios you come under:

A. If you are in a high income tax bracket for the current year, or
B. If you are in a low or no income tax bracket for the current year.

If you are in Scenario A the overall strategy is to accelerate tax deductions into the current year and postpone income into the following year. If you are in Scenario B the overall strategy is to do the opposite - accelerate income into the current year and postpone deductions into the following year. You also do not want to waste deductions.

**NOTE**: Although it could be, year-end tax planning does not have to be as late as December. It can be earlier in the current year such as September or even July for mid-year planning. You always plan in advance.

**Overall Strategy**: Before year-end, you should do a preliminary tax analysis to see if you are in Scenario A or Scenario B. To accomplish this you should do two procedures:

1. Review your last’s year tax return and especially look for carry forward deductions (see below).
2. Once you do number 1, and then do a tax summary of income and expenses for the current year up to the latest date possible, such as October 31 or November 30th.

When reviewing your last’s year tax return, you should look for the following carry forward deductions:

(1) **Unused loss or deductions carryovers.** Examples are, net operating loss (NOL) carryovers, unused passive loss carryovers from rental real estate, unused capital loss carryovers (such as from stock or bond sales). There can also be deduction carryovers such as first-year expensing, investment interest and unused charitable deductions. Also any carryovers of unused tax credits, such as rehab or low-income housing credits.

(2) **Full deductions for the unamortized balance of items that expire such as the remaining balance of with the loan being paid off.** For example, you acquire (or refinance) a rental property and incur $3,000 of points on the mortgage loan. Because this is not your primary residence, you must amortize the $3,000 points over the life of the mortgage, which has a 30 year term.

You therefore write-off $100 per year ($3,000 divided by 30 yrs.). Five years later you sell the property and the mortgage is paid off. The remaining $2,500 unamortized portion now becomes a full deduction in one year. If this occurs in the current year, you have available the full deduction for this current year.

(3) **Depreciation or amortization deductions for assets acquired in years prior to this one.** Once you have set the asset up on a depreciation schedule, your tax return software should automatically compute these deductions for the current year. However, technology is not infallible. Make sure that this is done.
(4) **Interest deductions.** As long as you have loans on property, you will have interest deductions every year as per your amortization schedule.

**Scenario A: If you are in a high income tax bracket for the current year.** The following recommendations will be based on Scenario A, accelerating deductions into the current year and postponing income into the following year.

1. **SETTLE ON A RENTAL PROPERTY BY 12/31.** Buying real estate anytime during the year will yield valuable deductions. Before year-end you can incur rental property expenses such as repairs, utilities, insurance, association fees and other operating expenses. You will also be entitled to some depreciation deductions (more than you think). On the building portion, you will be limited because for partial years the amount of the depreciation is prorated according to the number of months placed in service. Therefore, if you settled in December, you would only be entitled to claim one month of depreciation. However, with componentizing, for the 5-year personal property and 15-year land improvements, the first year is an automatic 6 months of depreciation, regardless of when the property is placed in service, even 12/31 (in some cases it may be a quarter or 3 months; but generally it will be 6 months as per the above). You can also elect the accelerated method for personal property and land improvements. Here is one that is little-known -- existing property components in the property that you replace, “gut out”, (such as plumbing, electrical or the heater) can give your huge non-cash deductions as they can so be fully written off for the current year.

**Additional Reference: Chapters 12 Chapter 12C**

2. **USE FIRST-YEAR EXPENSING FOR IMMEDIATE WRITE-OFFS OF BUSINESS ASSETS -- EVEN IN DECEMBER!** With Section 179 first-
year expensing, you can receive an upfront write-off of up to $250,000* all in one tax year for qualifying personal property.

*NOTE ON 179 ANNUAL LIMIT: The 179 expensing annual limit is subject to change just about every year. For a current exact amount email us with your Renaissance VIP code.

Instead of using 5 or 7 year depreciation, use Section 179 to fully write-off business assets such as computers, printers, scanners copiers, faxes, office furniture, fixtures, etc. You still get the full deduction even if the business asset (computer, fax, etc.) is placed in service on the last day of the year up until 12 midnight, December 31. You do not have to pro-rate the Section 179 limit. You write-off the entire cost (up to the limit), even if you do not pay for the assets, but financed them with your VISA or a lease-purchase arrangement. For example, assume you are in a 40% bracket. Just before year-end, you buy $10,000 of business of equipment. You immediately save $4,000 in taxes and can reduce your next year’s January 15th estimated tax payment accordingly.

First-year expensing as it pertains to personal property in real estate:

Section 179 cannot be used for: Personal property (appliances, carpets, furniture, etc.) in residential rental properties as per Section 50(b). In also cannot be used for air conditioning or heating units in any type of property. See The Small Business Act of 1996.

Section 179 can be used for: Personal property in commercial property, hotels, and motels. Apparently, it can also be used for personal property in vacation rentals where the average tenant use is 30 days or less and significant personal services, such as maid services, are provided (similar to hotels). It can also be used for personal property associated or ancillary to any type of investment
real estate, residential or commercial. Examples are: computers, faxes, furniture, etc. used in a home office to manage properties. Also included here would be maintenance equipment such as trucks, tractors, trailers, lawn mowers, snowmobiles, tools, etc. These would also qualify.

Additional Reference: Chapters 13

3. PREPAY SOME OF NEXT YEAR'S REAL ESTATE TAXES BY DECEMBER 31. This can be done for your rental properties; as well as your primary and vacation home (but deducted on IRS Schedule A). If you pay these taxes directly this technique is more easily accomplished. However, if the taxes are escrowed through a mortgage company, then you must advise the company well in advanced to prepay the real estate taxes. *Reason:* You are not entitled to the deduction until the mortgage company pays the taxes to the taxing authority.

4. PREPAY ONE MONTH OF MORTGAGE INTEREST. You can obtain a one-time increase in your mortgage interest deduction by prepaying the January payment by the end of December. (The January payment includes December's interest.) This will give you 13 months of interest deductions in the current year. The IRS allows one extra payment of monthly interest in one year. You can only do this once, but *once for each property*, including your residence (deducted on IRS Schedule A). Next year you will have to prepay January again in order to have 12 months of deductions. However, it can be worthwhile doing, especially in a high bracket tax year such as when you have had a taxable gain from the sale of investment real estate (and you did not do a 1031 tax-free exchange or other tax-deferral gain-reduction strategy.)

**STRATEGY:** Make the extra payment enough in advance so it will be received and processed by the lender *before* December 31. Verify that the lender has reported it correctly to the IRS via Form 1098. Double check the
above with your own amortization schedule to compute the 13 months of interest deductions. Even if the lender’s Form 1098 does not report the full 13 months interest, you are still entitled to the deduction, provided you paid for it before December 31.

5. **PREPAY PROPERTY REPAIRS BY DECEMBER 31.** Preventive maintenance, deferred maintenance and other necessary repairs should be scheduled and paid for by the end of the year. Do winterizing, bleed water heaters, clean furnaces. Do cosmetic work. You may be able to deduct contractor advances paid by December 31.

6. **BEFORE THE END OF THE YEAR, STOCK UP WITH HARDWARE AND OFFICE SUPPLIES** -- You can fully deduct these types of items if they have a useful life of less than a year, even if the useful life extends in part to the next tax year and the supplies or materials are not used up in the year of purchase, Reg. 1.162-3; RR 73-357; *Harold W. Guenther*, TC Memo. 1975-194. Put them on your “business” credit card.

7. **PREPAY RENTAL PROPERTY INSURANCE BY DECEMBER 31.** You may receive a discount for doing this.

8. **PAY BY 12/31 ANY FAMILY MEMBERS WHO HAVE ASSISTED IN THE MANAGEMENT OF THE PROPERTY (OR YOUR OTHER BUSINESS).** You can pay reasonable compensation to a spouse or to children who help you in duties such as typing, mailings, thank-you notes, dropping off flyers, mail runs, answering the phone, cleaning the "business" car & office, recordkeeping, operating your business computer, postage meter, web page, keep tract of supplies and other administrative and management tasks. Such
compensation is a tax deduction to your business. IRS Revenue Ruling 72-23. Although the age of the child can be a factor, deductions have been allowed for wages paid to children as young as 6 or 7 years old, provided they are capable of doing the work [Denman, (1967) 48 TC 439(A); Eller, 77 T.C. 934, acq. 1984-52 IRB 5]. Even babies using their photos in your marketing media. By doing this, you convert non-deductible allowances into deductible business expenses. Your children can earn up to $6,000 without paying federal income taxes, plus there is no kiddie tax on earned income. For example, assume your total tax bracket is 30%. By paying your child $6,000 in salary, you reap tax savings of $1,800, while the child does not owe anything. (Plus: The child can still set up a tax-free Roth IRA). This strategy can also work for other family members such as grandchildren, nieces, nephew or retired parents. You do not have to pay the compensation throughout the entire year. You can pay for these services of family members by the end of the year for the entire year, provided that they have been bonafide employees and you have records. Also, pay any bonuses, within reason. You also can take advantage of deductible fringe benefits, such as retirement plans or medical reimbursement plans (see next).

**Additional Reference:** Al Aiello’s Tax Bible Course

**9. SET UP A MEDICAL REIMBURSEMENT PLAN BY DECEMBER 31 AND FULLY DEDUCT FOR THE ENTIRE YEAR, A 100% OF ALL MEDICAL EXPENSES AS A BUSINESS DEDUCTION.** A “Medical Reimbursement Plan” (or a “105(b) Plan”) is a legal fringe benefit plan that permits self-employed individuals to claim full business tax deductions for medical expenses, with no limit such as on Schedule A. The deduction is claimed by reimbursing employees (including spouses and other family members) for medical insurance premiums and other uninsured medical expenses. It is ideal for small business owners who hire their spouse as an employee; or can be done through a c-corporation (which can be a minority
(low percentage) member of your real estate LLC per Chapter 5B). The spouse can be part time and still have another job. Qualifying businesses are also rental property owners and real estate professionals who are independent contractors. The Medical Reimbursement Plan is far superior to the Self-Employed Health Insurance Deduction. Instead of deducting only a certain percentage of health insurance, one can deduct 100% of medical insurance, plus 100% many of other medical expenses that would generally be eliminated by the adjusted gross income limitations for medical deductions on IRS Schedule A. In addition, besides federal income taxes, the plan deductions can reduce the nasty bite of other taxes -- Social Security, Medicare, state & local taxes. Plus, the deductible medical reimbursements are tax-free to the family-employee.

**EXAMPLE** Your spouse has another job but also works for you as a part time assistant 20 hours a week, at $10 an hour at an average of 20 hours a week over a period of 50 weeks or 1000 hours. Therefore the total annual compensation is $10,000. Your spouse incurs $5,200 in medical insurance premiums and $2,800 in uninsured medical expenses. You will also pay your spouse $2,000 in wages. The total annual compensation is $10,000 as follows:

$2,000 Salary  (A $2,000 IRA would reduce this to zero)
5,200 Medical Insurance Premiums*
2,800 Medical expenses* (not covered by ins.)
$10,000 Total Compensation.

*Triple play! Of the total compensation of $10,000, the medical insurance and expenses totaling $8,000** are:

1. **Fully deductible** by you as a business expense
2. **Tax-Free** to your spouse (which also includes *you* on a joint return), and
3. **Free** of payroll taxes.
** In a 40% tax bracket, the $8,000 deduction equates to tax savings of over $3000 a year!

**NOTE:** Prior to a 2002 IRS ruling, you could have elected to have the plan retroactive* at any time during the year, up until December 31, for all medical costs and premiums for the *entire* current year. But see the update alert below.

**UPDATE ALERT:** In a recent ruling the IRS has stated that medical reimbursement plans cannot be retroactive. Payments for medical costs incurred before the plan is taxable. Only subsequent costs qualify, Revenue Rul. 2002-58.

**STRATEGY:** But IRS rulings do not have the force or effect of law. However, despite this plan ahead of time to have your documents dated at the inception of claiming medical costs as part of a medical reimbursement plan.

**Additional Reference:** To qualify for the medical reimbursement plan, you must meet IRS requirements and have the proper forms. All the requirements, forms and instructions are contained in Albert Aiello’s *Medical Reimbursement Plan Kit.* With the kit, it is easy to set up the plan yourself and save hundreds of dollars in professional fees (plus the taxes). The kit also includes over 120 medical deductions, many large, many overlooked. No longer does one have to throw away medical deductions!

**10. GIVE & DEDUCT BUSINESS GIFTS.** Holiday time is a good time to start giving tenants, clients, referrals, bird dogs and associates gifts of liquor, candies, potpourri, etc. The amount of the gift deduction is limited to $25 per person. *Greeting cards* are fully deductible (no $25 limit) with your business
name on the card and mailed to tenants, clients, prospects, etc. The cost includes, cards, postage and handling.

11. PREPAY YOUR NEXT YEAR’S INVESTOR ASSOCIATION DUES. Also dues paid to civic or public organizations, such as Rotary, Lions and Kiwanis are deductible.

12. RENEW SUBSCRIPTIONS. Those for real estate, tax & management newsletters, such as Mr. Landlord (www.mrlandlord.com; 1-800-950-2250). You can pay for them in December and get deductions this year.

13. WHILE YOU ARE OUT CHRISTMAS SHOPPING STOP OFF AT THE BOOK STORE. Buy real estate and other business related books. You may also want to buy Christmas gifts for your good tenants. Put them on your business credit card, deduct them in December and pay for them next year. (See Strategy 27)

14. WRITE OFF NEXT YEAR’S BUSINESS AUTO EXPENSES THIS YEAR! If you plan to do some major repairs to your business auto next year (such as tires, reupholstering, body work, etc.), pay for them for this year and receive a current deduction.

15. PREPAY ACCOUNTING AND LEGAL EXPENSES. Pay any retainers in advance. Make sure the bill is dated before the end of the year.

16. MARKETING POWER WITH BUSINESS ENTERTAINMENT. Lunches, dinners, and parties directly related to business can be held around a festive time of the current year, such as Christmas. Entertainment deductions can be incurred in the current tax year.
17. REMEMBER TO DEDUCT ENTERTAINMENT AT COUNTRY CLUBS. Dues to country and health clubs are no longer deductible, even if they are business related. However, you still can deduct business entertainment at these clubs (50% of the cost.)

18. BOOK REAL ESTATE CONVENTIONS NOW. If you are planning to attend a real estate conference the following year, you can prepay for it in December and secure a deduction for this year. Book your airline tickets on your credit card for an immediate deduction. (Plus: Some seminars and airlines give discounts for prepaying; it is easier to use points when booking flights earlier.)

19. PREPAY OTHER PROPERTY OR BUSINESS EXPENSES. Such as utilities, condo association fees, promotional materials, travel expenses, telephone, professional dues, business stationery and any other business expenses.

20. TO SECURE THE YEAR-END DEDUCTION, MAKE SURE THE CHECK IS MAILED BY DECEMBER 31 OR USE YOUR CREDIT CARD BY DEC. 31. (See Strategy 27)

21. POSTPONE INCOME. Another way of reducing your taxes for the current year is to hold off receiving income (such as fees, commissions, etc.) until January of the next year. You or your spouse can do the same for year-end company bonuses.

However, for rent income, this may not always be practical. You do not want to hold off December 1 rents until January of next year for two reasons: (1) You need the funds to timely pay the mortgage or other property expenses, and (2)
You do not want your tenants to develop late paying habits. However, this could work where a tenant is late anyway. For example, they may be paying in late December, or their lease has a later monthly payment date. If you receive advance rents in late December from a new tenant and cannot get to the bank to make the deposit, you could postpone this rent income until January. (Barring the rules of “constructive receipt”).

**STRATEGY: Security deposits are not taxable.** This is so provided that the payment is for the security for the performance of the tenant’s obligation and is to be refunded in accord with the lease in the absence of default, *George E. Barker Estate*, 13 BTA 562. They are still not taxable, even if the landlord does not segregate the funds and even uses the funds for their own purposes, *Warren Service Corp.*, 110 F.2d 723. (They do become taxable when they are forfeited by the tenant.)

**21A. POSTPONE GAINS.** If you are selling appreciated property at the end of the year, arrange to do installment sale reporting. You can do this by postponing the receipt of some of the sales proceeds until January of the following year.

---

**Additional Reference:** “A one payment installment sale”, see *Chapter 39*. For other ways to defer or eliminate gains on the sale of investment property, see *Chapter 31*

---

**OTHER YEAR-END TAX PLANNING STRATEGIES FOR SCENARIO A**

**22. DEDUCT PAYMENTS TO YOURSELF THROUGH RETIREMENT PLANS.** Because of early tax-free compounding on the earnings, you should
make maximum tax-deductible contributions to retirement plans as soon as possible during the year. If you have not done so, you should open up a self-employment retirement plan such as a qualified plan or SEP plan. Qualified plans must be opened before December 31 of the current year to secure deductions for that year. This can be easily done by making application at a bank or brokerage firm with a minimal deposit, such as $100.

But SEP plans can be opened and funded after 12/31 for a plan deduction for the prior year.

You can significantly extend the period for securing deductions for as long as 9-1/2 months past December 31 of the current tax year, by filing the proper tax return extensions.

**Additional Reference:** Al Aiello’s *Tax Bible Course*

**23. PREPAY QUARTERLY STATE OR LOCAL ESTIMATED TAXES.** Besides estimates for federal taxes, self-employed taxpayers frequently must pay quarterly state or local estimated taxes (which are deductible on Schedule A for federal income tax purposes). For the last quarter of the current year, such estimated taxes are generally due by mid January of the following year. But to secure a current federal tax deduction, pay these taxes by December 31 of the current tax year.

**ALERT:** If you are already in an alternative minimum tax (AMT) situation, then you should not prepay the state or local estimated taxes because it will not benefit you in this particular scenario.

**Additional Reference:** Appendix F
24. SELL OFF LOSER INVESTMENTS. Any loser stocks or bonds that can be sold by the end of the year will generate capital losses which can be used to fully offset capital gains from real estate or from other stock. Up to $3,000 of such losses can be taken against ordinary income with the remaining unused losses carried over (indefinitely) into future years.

Additional Reference: Chapters 28  Chapter 44

24A. DEDUCT FORFEITED DEPOSITS OR OPTION PAYMENTS ON INVESTMENT PROPERTIES AT YEAR-END. To do this, it must be shown that the forfeited deposit or option payment is clearly not going to be refunded to you. This could be documented by agreements or other written correspondence. If the deposit is ever refunded to you, you must report it as income in the year received.

Additional Reference: Chapters 40-A

25. “BUNCH” MEDICAL EXPENSES. Medical expenses must exceed 7-1/2% of your adjusted gross income (“AGI”) in order to generate a deduction on Schedule A. Therefore you should "bunch" medical expenses into the year that they will be most beneficial. Dental, eye, and physical check-ups can be scheduled this year or next, as can some types of voluntary surgery. If you have a Medical Reimbursement Plan, you can deduct 100% of medical costs as business expenses on a business schedule and not on Schedule A with its deduction limits. (See Strategy 9).

26. CHARITABLE DONATIONS. Make a large contribution to your church in December instead of small donations each week. Mail the payments or charge them on credit cards by December 31. (You must obtain a receipt for each separate donation of $250 or more.) Make non-cash donations to charities
by gathering up old clothes, unwanted books, junk furniture, etc. Donate them to a charity such as Goodwill or the Salvation Army. You deduct the fair market value of the items donated.

**TIPS:** (1) List the non-cash donations items individually on with their fair market value. Obtain a receipt from the charity.

(2) If the amount of the non-cash deduction is $200 or more, then you should attach to your 1040 a copy of the receipt and the list of items. For non-cash contributions that exceed $500, IRS Form 8283 must be completed and attached to your 1040.

(3) Items valued at $5,000 or more require a written appraisal. (See IRS Publications 526 and 561).

Charitable donations are claimed on Schedule A

26A. **DONATE APPRECIATED SECURITIES.** If you are going to donate cash to a charity, instead of cash, donate an appreciated stock to a charity and get a deduction (on Schedule A) for the full market value (provided that the stock is held long-term, one year and one day). Moreover, you escape capital gain tax on the appreciation. Thus, you get a double play: (1) Receive an appreciated non-cash deduction and (2) avoid paying capital gain taxes.

27. **USE CREDIT CARDS AS A TOOL FOR YEAR-END TAX PLANNING.** Sometimes at the end of the year (esp. holiday time) you may be a little short of cash to prepay deductions. Using a credit card (such as VISA or MasterCard*) directly, or as a cash advance, is one way to solve this problem. The IRS allows the deduction if the card is charged before December 31, even if paid the following year*.
*ALERT*: This does not apply to retail store credit cards. Use VISA, MasterCard, AMEX, or Discover.

28. **YOU CAN DEDUCT BUSINESS CREDIT CARD INTEREST!** Credit card interest is not deductible if used for personal reasons. But interest on credit cards segregated *solely* for business can be deductible in full as "business interest" on your business or rental property tax schedules. The key strategy is a separate credit card for business use only. Use the credit cards that you give you an annual summary itemizing your business expenses.

   **Additional Reference: Chapters 28  Chapter 22**

**YEAR-END TAX BREAK:** If deductible items are paid by check at year-end and mailed by year-end, the deduction can still be claimed for the current year, even if the check arrives to its destination the following year.

**NOTE:** For bills paid electronically, the paid item is deducted in the year your account is debited on the statement, which should be on or before December 31 of the current year.

**Scenario B: You are in a low or no income tax bracket for the current year.** Here, employ the following strategies:

29. **ACCELERATE INCOME INTO THE CURRENT YEAR AND POSTPONE DEDUCTIONS INTO THE FOLLOWING YEAR.** Essentially this strategy is the opposite of the above Scenario A strategies.

30. **WITH EXCESS LOSSES TAKE ADVANTAGE OF AN NOL.** Basically, an NOL (or net operating loss) happens when your business and
rental property losses exceed all of your other income resulting in a negative taxable income. If your “total income” on page 1 of your 1040 is a negative amount, then most likely you have an NOL. An “NOL” is not just a loss, such as a Schedule C or Schedule E loss. It is a loss in excess of your other income. It results from business and rental losses. The benefit of an NOL is that it can be carried back 2 years (presently) to recoup past due taxes or carried forward 20 years to offset future taxable income. For NOL carrybacks (for refunds), use IRS Form 1045 as a “quick refund” claim. Do not attach or file the 1045 with your 1040. It is filed separately. You have 12 months to file Form 1045 after the end of the tax year. After the one year, you must then file IRS Form 1040X. Refer to Chapter 28.

**Additional Reference: Chapters 28**

**31. ACCELERATE ANY GAINS TO OFFSET LOSSES.** Another strategy than can be applied in low or no income situations is to accelerate potentially taxable gains. Any losses can then be can be used to offset the gain, which would no longer be taxable.

**EXAMPLE:** You have incurred a stock loss of $20,000 for the current year. Because a loss on the sale of stock is considered a “capital” loss, it is limited to only $3,000 a year as a deduction against ordinary income. The remaining unused loss can be carried forward (not back) indefinitely. However, assume you have another winner stock that has gone up in value by $20,000. Because the $20,000 increase in value is a “capital” gain if it is sold, it can be fully offset by the $20,000 capital loss on the other stock. With the full offset, you have no taxable income, yet you now have $20,000 tax-free cash in your pocket.
**TIP:** If you think the loser stock will again become a winner, you can buy it back in 31 days from its sale and still be entitled to the above loss deduction.

Similar strategies can be done for the carryover of real estate passive losses which can be used to reduce the gain on the sale of the real estate.

**ALERT:** With this type of planning, you have to make sure that certain types of losses can be used to offset certain types of gains. Also check your state & local tax laws.

**Additional Reference:** Chapters 28 Chapter 44

32. **DO NOT WASTE DEDUCTIONS.** An important part of tax reduction planning is not wasting deductions. This is especially so when you are in what I call a “limbo layer of deductions”. This is where your present business loses are enough to offset most of your other income, but not all of it. However, whatever other income is not offset by business losses is offset by your personal itemized deductions and personal exemptions. In this situation you will not have an NOL. Here you really do not need any more deductions. Any more may be wasted if used in the current year. You therefore should save deductions for future years. Here, you could do some *opposite* planning by accelerating income into the current year and postponing deductions into the following year. Instead of fully deducting certain items, you can capitalize them and use slower methods of depreciation such as for rental properties and other business assets. On your rental properties, instead of expensing repair items, you can treat them as capital improvements and depreciate them over a number of years. The result of this type of planning is that you “bank” your deductions for future years, instead of wasting them into “limbo”.

**Additional Reference:** Chapters 28
33. YEAR-END TAX PLANNING SHOULD BE DONE WITH COMPUTER SOFTWARE PROGRAMS, such as *Quick Books* for recordkeeping and *TurboTax* for tax preparation and planning. These will speed the planning process and ensure more accuracy.

Reference source (return tab): – SAP 36

ALL RIGHTS RESERVED BY STRICT COPYRIGHT LAW

Copyright - All Rights Reserved. Printed in the United States of America. First edition. Copyright - Information Services Unlimited (ISU). Please respect the thousands of hours invested to research and create this intellectual work and our rights to this material. No part of this program may be sold (including on the internet), transferred, reproduced by any means, stored in any information retrieval system or transmitted in any form or by any means without the specific written permission of ISU. Legal action will be brought against you and/or your company if you are found to have made ANY unauthorized copies of these materials, in part or in whole. Unauthorized copying is AGAINST THE LAW, regardless of intent: No matter if you make a profit or not, you are committing a serious copyright infringement crime, punishable by severe fines and imprisonment, and you may be held liable under BOTH civil and criminal law.