The Tax Smart LANDLORD

"Tax Smart" Strategies For Landlords To Save Thousands In Taxes Every Year

By Ted Lanzaro,

CPA, Real Estate Broker

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The Tax Smart Landlord

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Introduction

Why be a "Tax Smart" Landlord?

This book is designed for real estate investors; primarily landlords involved in buying, leasing and selling residential and commercial real estate. If this is you, you now have in your hands a "plain English" guide on tax reduction strategies written specifically for real estate investors. The fact is that most tax books and articles are written by college professors and other academics. I am not an academic. I am one of you, a real estate investor. I am also a nationally recognized Certified Public Accountant and real estate broker. In this book, I will give you the necessary information you need to save thousands of dollars annually on your taxes and do it in an easy to understand, straight forward manner.

As a real estate landlord, you may spend more money on taxes than on any other expense. You probably spend more on taxes than you do on housing, insurance, food, transportation, and utilities. The money you spend on taxes allows your local, state and Federal government to provide services to you. **But, you do not get any better service by paying more than you need to**. In fact, all you end up doing is paying more than your fair share of the burden of providing these services.

Did you know that it is almost impossible to build wealth

quickly without minimizing the amount of taxes you pay? Bill Gates, founder of Microsoft and one of the richest men in the world attributes much of his wealth to his working knowledge of tax law. This book will give you the tools you need to implement the strategies that will minimize your annual in come and help you build wealth from your real estate investments. Simply stated, the less in taxes you pay, the more money you have left over to re-invest and create wealth.

You might think that your accountant is already doing this for you. **You would be incorrect!** Most accountants do not have the necessary real estate industry experience to proactively help you reduce your income taxes. Most likely, all your accountant is doing for you is filling out tax forms with the information you provide him. In my experience, this "reactive model" is how 90% of real estate landlords have their taxes prepared by their accountant.

Expecting your accountant to get you the most tax effective treatment on all of the aspects of your real estate landlord business is like expecting your doctor to maintain your body in excellent working condition. All he would have to do is be with you 24 hours a day/seven days a week reminding you what to eat, how much to exercise, etc. It is up to you as a real estate investor to be "proactive" and to use the knowledge you get from this book to implement the tax strategies that will allow you to minimize your taxes and build wealth.

Basic Real Estate Tax Strategies

Chapter 1

USE TAX STRATEGIES TAILORED FOR YOU

Tailoring the tax strategies you use is the very essence of planning your taxes in order to minimize the amount you pay. It means using the correct strategies at the correct time and in the correct manner for your unique situation. It also means implementing the correct amount of documentation to safeguard the strategy from the IRS.

The biggest problem I have seen with publications by other authors is that they just describe tax strategies in general without telling you, the reader, whether or not the strategy is actually applicable to you.

Tax reduction strategies need to be tailored because each individual's tax situation is unique based on

- How many properties they own
- Whether they have earned income from a job or a business
- Whether they are active or passive investors
- The amount of their earned income
- Their ability to qualify as an active investor or real estate professional
- Their goals and limitations
- Based on these and many other factors, a tax strategy that might be good for one landlord might be awful for another.

Tax $mart Tip #1

Make sure you have on your wealth team a CPA who is a real estate investor like myself. Have him/her review your situation and tailor tax reductions strategies specifically for you. If they can't do that, find someone else who can.

Chapter 2

KEEP GOOD RECORDS

Good record keeping means capturing and keeping documentation on all of the transactions related to your real estate business including:

- Purchasing your properties
- Selling your properties
- Financing your properties
- Maintaining your properties
- Leasing your properties
- Managing your properties

Good record keeping is the foundation for taking advantage of all of the tax strategies discussed in this book. Like a house needs a strong foundation, so does your real estate business tax philosophy. Without solid record keeping, the numbers your accountant puts on your tax returns and the strategies from this book that you implement cannot be supported if you get audited.

How you keep your records really depends on the size of your real estate business. If you are an investor who owns one multi-family house, you may simply be able to keep track of your income and expenses on a column paper or an excel spreadsheet. A real estate company that owns

shopping centers, office buildings or multiple residential rental properties and may have a few employees probably needs a more sophisticated computerized accounting program like QuickBooks. The larger the business, the more sophisticated the accounting software you may require. Larger businesses may also choose to employ a company bookkeeper or accountant depending on their size.

Tax $mart Tip #2

Keeping good records = ability to use tax reduction strategies.

All of the tools you need to keep good records for your real estate leasing business can be found in the “Tax Smart Landlord” toolkit which you can purchase at www.taxsmartlandlord.com

Chapter 3

AVOID RECORD KEEPING NO-NOS

Record keeping No-Nos are things you do not want to do as part of your record keeping system for your rental properties. These are actions that will make it more difficult for you as a landlord to capture all necessary transactions, keep proper documentation and ultimately defend yourself if audited.

Record keeping No-Nos include

- Commingling business and personal funds
- Paying expenses using numerous credit cards and bank accounts
- No filing system for transactional documents
- No separation of income and expenses by property
- No necessary audit proofing documentation prepared

Commingling business and personal funds

This is a no-no for several reasons –

- It can void your asset protection strategy if your properties are in business entities
- It makes it more difficult to capture all rental business related transactions resulting in lost deductions
- It produces an audit trail that is difficult to follow and potentially can give an auditor personal information that they should not have

Paying Expenses Using Numerous Credit Cards and Bank Accounts

This is a no-no because –

- It makes it more difficult to capture all rental business related transactions resulting in lost deductions.
- It produces an audit trail that is difficult to follow and potentially can give an auditor personal information that they should not have

I see this happen a lot with new investors. They pay rental business expenses from whatever source they have the available funds. Sometimes, this is a necessity but should be avoided if possible.

No filing system for transactional documents

This is a no-no because you need to be able to access your transactional documents as needed to be able to document your tax strategies and safeguard your documents in case of audit.

No separation of income and expenses by property

This is a no-no because you want to be able to separately report income and expenses for each property. From a property management standpoint, it is also helpful to know which properties are making a profit and which are losing money. The same concept applies to cash flow – you want to know which properties generate cash and which

properties are draining your cash.

No necessary audit proofing documentation prepared

The last big no-no is not implementing the necessary record keeping procedures to produce the audit proofing documentation you will need to maximize and protect your tax deductions.

Tax $mart Tip #3

Avoid these No-No's. The "Tax Smart Landlord" toolkit gives you the necessary forms, formats, checklists and spreadsheets to be able to safeguard your tax return and protect your valuable tax deductions.

Chapter 4

HAVE A GOOD ACCOUNTING SYSTEM

An accounting system is a means of accumulating transactional data for a business and organizing it in an efficient manner to produce the necessary information and reports you need to run the business effectively, be compliant with tax reporting requirements, and minimize tax liabilities.

I am a big proponent of choosing an accounting system based on the abilities and comfort level of the person running it. I never like to force a client to use a system they don't like or are not comfortable with because they will either do a lousy job or not do it all.

My clients basically use three types of systems –

- Paper system – summarizing transactions by category on columned paper.
- Computer spreadsheet system – summarizing transactions by category using a spreadsheet program like Microsoft Excel.
- Computer Accounting Software – computer software that uses a double entry accounting system to account for transactions. QuickBooks is the most popular brand of this type of accounting software currently in use for rental property businesses.

A good accounting system ...

- Accounts for all transactions of a rental business
- Provides an audit trail for the landlord
- Makes preparing reports needed for management, compliance and tax minimization easy
- Makes it less expensive to have your taxes prepared
- Makes it easier to document and protect your tax deductions

Tax $mart Tip #4

The most current version of QuickBooks Pro will work well for landlords and can be purchased online or in an office supply store. Contact me for tips on setting up your QuickBooks company file properly.

Chapter 5

AVOID BEING A PASSIVE INVESTOR

Being a passive investor is a classification that means not being able to deduct rental losses against other income on your tax return.

You are a passive real estate investor if:

- You own less than 10% of a property
- You have no substantial involvement in the management of the property
- You have property managers managing the property. This applies even if you perform some tasks for the property
- You qualify as an active investor but your adjusted gross income from other sources is too high to deduct rental losses.

Your classification as either passive or active determines your ability to deduct rental losses against your other income. One of the big advantages of owning rental properties is that you can shelter cash flow by using the depreciation deduction to offset the net rental income. If you are a passive investor, your ability to shelter cash flow is substantially limited.

Tax $mart Tip #5

Avoid being a passive investor if you can. If you cannot, there are still strategies here that will work for you, but they are more limited than if you qualify as an active investor or real estate professional.

Chapter 6

BE AN ACTIVE INVESTOR

Being an active investor is a classification that means you can deduct up to $25,000 of rental losses annually against other income subject to certain limitations.

You are an active real estate investor if:

- You own more than 10% of a property and
- You have substantial involvement in the management of the property.

Your classification as either passive or active determines your ability to deduct rental losses against your other income and avoid passive loss limitations. As mentioned in the last chapter, one of the big advantages of owning rental properties is that you can shelter cash flow by using the depreciation deduction to offset the net rental income. As an active investor, you can also use up to $25,000 of rental losses to offset income from wages, businesses and other sources.

If you are an active investor:

- You can deduct up to $25,000 per year of rental losses against income from non-passive sources like wages or self-employment income.
- The $25,000 of allowable losses can be phased out for taxpayers whose adjusted gross income exceeds

$100,000 per year and is completely phased out at $150,000 of adjusted gross income.

- Allowable losses or losses exceeding $25,000 per year that are not deducted in the current year are carried over to the next year.

Tax $mart Tip #6

Qualifying as an active investor has huge tax advantages. You must keep records of the time you spend managing your properties. The tools you need to do that can be found in the "Tax Smart Landlord" toolkit available at www.taxsmartlandlord.com

Chapter 7

QUALIFY AS A REAL ESTATE PROFESSIONAL

An individual who qualifies as a real estate professional can take unlimited losses from rental properties against their earned income.

You qualify as a real estate professional if you meet all of the following criteria:

- You are involved in the operations of the rental activity on a regular, continuous and substantial basis.
- At least 50% of your personal services during the tax year are performed in real property trades or in a business in which you materially participate.
- You spend more than 750 hours of service during the tax year in real property trades or businesses in which you materially participate.
- You are in the real property trade or business that includes real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operations, management, and leasing or brokerage businesses.

Your classification as a real estate professional determines your ability to deduct rental losses against your other income and avoid passive loss limitations and active investor income phase-outs. As a real estate professional, you can use unlimited rental losses to offset income from wages, businesses and other sources.

Tax $mart Tip #7

Landlord investors should keep time logs by property summarizing the hours spend performing various tasks related to the management of the rental property. In addition, to qualify as a real estate professional, you must also document the hours you spend in your real estate trade or businesses and the hours you spend in any business not related to real estate. The tools you need to do that can be found in the "Tax Smart Landlord" toolkit available for purchase at www.taxsmartlandlord.com

Chapter 8

AVOID OVERPAYING YOUR ESTIMATED TAXES

Self-employed business owners and real estate landlords need to pay the appropriate amount of estimated taxes every quarter. The amount of the estimated payment is based on your current estimates of your income.

Estimated tax payments are used to pay taxes on your income that is not subject to tax withholding. If you do not pay income taxes on your income from sources that are not subject to tax withholding, you will be subject to penalties for underpayment. In addition, if you do not pay your estimated taxes by the proper due date, you may be subject to penalties for late payment.

But, if you overpay your estimated taxes, you are giving the government an interest free loan and tying up cash flow that can be used for investing in more properties, managing your properties, or paying personal expenses.

You may be required to make estimated tax payments on your income from:

- A sole proprietorship, LLC, or S corporation
- Interest and dividends
- Net rental income
- Capital gains from sales of property and other

investments

- Alimony
- Other sources of income

Estimated tax payments are due on the following dates:

- April 15th
- June 15th
- September 15th
- January 15th of the following year

Tax $mart Tip #8

Meet with your accountant every quarter to calculate the amount of estimated payments due. This will keep you from overpaying or underpaying your taxes every year.

Chapter 9

DO TAX PLANNING ANNUALLY

Tax planning is the process of developing a tailored, strategic plan to minimize the amount of income taxes that must be paid on your income annually.

One of the biggest mistakes made by real estate landlords is waiting until it is too late to assess the tax impact of your rental income and real estate purchase and sale transactions.

If you do not do annual tax planning, you are missing out on strategies that have to be implemented prior to year end in order to be effective. In essence, you are voluntarily overpaying your income taxes.

There are several reasons why real estate landlords avoid tax planning:

- •The tax laws are complicated and change frequently.
- •Landlords often fear an IRS audit if they aggressively pursue tax savings.
- •Landlords often do not think about their taxes until the filing deadline is imminent.

However, real estate landlords only need remember that the Internal Revenue Service only requires you to pay the amount of tax you owe under the current regulations and NOT A PENNY MORE!

There are several factors to consider when developing a tailored strategic tax plan for a real estate investor's unique situation. Tax strategies that provide the most benefit should take into account the following:

- How does the timing of a transaction impact the situation?
- What options are available to minimize your taxable income?
- Can you defer taxable income or tax payments without incurring a penalty?
- What is your marginal tax rate and how does a given transaction affect that rate?
- Do we have the ability to match high income with high expense?
- What is the effect of long term versus short term holding periods?

While each taxpayer's situation is unique, strategic tax planning basically consists of the following steps:

- Analyzing and obtaining an understanding of the taxpayer's situation and goals.
- Development of a strategic tax plan to minimize the current and future tax liabilities.
- Preparation of a tax projection which incorporates the strategic tax plan.
- Implementation of the strategic tax plan.
- Ensuring that the taxpayer has made sufficient tax payments to avoid a tax penalty.

Tax $mart Tip #9

You should implement strategic tax planning annually in order to reduce the amount of taxes you pay every year. Contact me at **ted@lanzarocpa.com** if you would like me to develop a strategic tax plan to save you thousands in taxes every year.

Section 2

Tax Strategies When Buying Real Estate

Chapter 10

USE COST SEGREGATION TO ACCELERATE DEPRECIATION

A Cost Segregation Study (CSS) is an engineering based study that allows a residential or commercial (non-residential) building owner to accelerate a substantial amount of the depreciation deductions on a building by identifying construction or acquisition costs that can be allocated to a shorter recovery period.

Cost segregation studies offer a tremendous opportunity to increase cash flow and defer tax payments until later years. It is a great tool to accelerate the return on capital from your investment in property.

The basic idea is to move building costs that would ordinarily be depreciated over 27.5 to 39 years to being depreciated over 5,7 or 15 years using the IRS approved, engineering based study as proof that the cost should be depreciated over a shorter life.

There are basically three steps used by engineers to complete the cost segregation study:

- Make an initial land to building cost allocation.
- Analyze land improvement costs for example, landscaping, fencing or paving.
- Analyze building costs by breaking costs into

component parts of the building and applying the correct depreciable useful life to them.

Any of the following types of properties can benefit from a cost segregation study:

- office buildings
- shopping malls
- strip shopping centers
- residential apartment buildings
- large leasehold fit-outs
- auto dealerships
- free standing out parcel buildings used for large retail stores or chain fast food restaurants
- hotels and resorts
- distribution warehouses
- manufacturing facilities
- industrial buildings
- self-storage buildings

Tax Smart Tip #10

Cost Segregation Studies are an incredible tool for tax savings on income producing properties. To find out if a cost segregation study can help you save thousands of dollars on your taxes every year, contact me at ted@lanzarocpa.com or visit **www.taxsmartlandlord.com/myteam**

Chapter 11

REDUCE THE AMOUNT OF COST BASIS ALLOCATED TO LAND

The original purchase price of an income producing property must be broken down between the portion that is attributable to the building, and land improvements which are depreciable, and the portion attributed to the land which is not depreciable.

Since land cost is not depreciable, the more cost basis allocated to the cost of the land purchased, the less depreciation deduction the property owner will receive over the life of the property.

Typically, an average accountant will use a shortcut called the "80/20" rule which is really not a rule at all. The accountant simply allocates 80% of the original purchase price to the building and 20% to the land. This shortcut will cost you money as an investor.

The most tax advantageous way of determining land cost basis is to use the following steps to break down the total property cost into four components in this order–

1. Tangible personal property – This is basically all the components of the building that can be depreciated over 5 to 7 years.
2. Land Improvements – These are things like

landscaping, driveways, sidewalks, fences and other items that can be depreciated over 15 years.

3. Building – This is the rest of the building that will be depreciated over 27.5 years (residential) or 39 years (commercial).

4. The remaining balance is allocated to the land and is not depreciated.

Tax $mart Tip #11

Avoid using the 80/20 rule to allocate the cost basis of the rental properties you buy, and hire a real estate specific CPA who knows how to break out the components of your building to maximize depreciation.

Chapter 12

USE SECTION 179 AND BONUS DEPRECIATION

Section 179 of the Internal Revenue Tax Code allows you to fully depreciate assets with useful lives of 5 to 15 years in the first year they are placed into service. Bonus depreciation allows you to depreciate 50% of the cost of an asset with a useful life of 5 to 15 years in the first year before you calculate the regular depreciation on the asset.

This is important as depreciation is what makes real estate a great tax shelter for cash flow. Depreciation is an allocation of the cost basis of a building and its components over the useful life of the components. You can deduct depreciation against the net income of a property even though you have not actually paid it out in cash. This means you pay less income tax on the cash flow your property produces.

You take Section 179 depreciation on fixed assets by making an election to do so in the year you place the assets in service.

The Section 179 expense limit was reduced from $500,000 a year to $25,000 a year when the tax law that created the larger limit expired at the end of 2013. Congress extended the law for 2014 in December 2014 and pending legislation in Congress could further extend the larger limit through 2016.

Bonus depreciation allows you to expense 50% of the initial cost basis of assets with 5 to 15 year useful lives in the first year they are placed into service subject to certain limitations prior to calculating normal depreciation.

You take bonus depreciation on fixed assets by making an election to do so in the year you place the assets in service.

The tax law that created bonus depreciation expired at the end of 2013 was also extended through 2014, and pending legislation could further extend it through 2016.

Tax $mart Tip #12

Maximizing depreciation deductions means more cash in your pocket and less tax paid to the government. Your ability to use this strategy is based on your CPA's understanding of how to break down the cost basis of a building into its depreciable components. Contact me at **ted@lanzarocpa.com** if you would like me to perform this service for you.

Chapter 13

TAKE ORDINARY LOSSES ON ABANDONED ASSETS

Building components removed during the renovation of an income producing property can be written off at their net cost basis to create an ordinary loss not subject to passive activity rules.

This is important because it creates a huge opportunity for an investor who purchases an income producing property that requires renovation to break out the individual building components (units of property) and then write off those components disposed of during renovation. A unit of property refers to the various building systems that make up a building.

This strategy is used primarily when demolishing and renovating a building that is used for business or income producing purposes.

The IRS requires a tax engineering firm to prepare an abandonment study report to document the deduction.

Tax $mart Tip #13

Assets abandoned during the renovation of an income producing property can result in a huge tax benefit. If you are purchasing an income producing property that you will be renovating, then this strategy can result in huge tax savings! A tax engineering firm must prepare a study to document the assets abandoned during renovation. For more information on this service, visit **www.taxsmartlandlord.com/myteam**

Chapter 14

USE TAX PLANNING WHEN CONSTRUCTING A BUILDING

Construction tax planning is the use of tax planning to identify tax benefits related to new and planned construction during the design and construction phases of a building. Taking a proactive approach to maximizing tax benefits as part of the design and construction of a building can save hundreds of thousands, if not millions, of dollars, to the owner of the building

Any building owner or business owner who is designing and building a new building, or redeveloping an old building should use this strategy.

The primary benefit of using this strategy is to identify opportunities to accelerate depreciation deductions by analyzing, documenting, and constructing in a manner that optimizes building components being categorized as personal property (5 to 15 years depreciation life), instead of real property (27.5 to 39 year depreciation life).

There are numerous other benefits to using this strategy that can save the building owner money including –

- Taking advantage of Federal energy efficiency incentives

- Taking advantage of state and local rebates and incentives
- Obtaining LEED commissioning
- Obtaining proper liability insurance coverage

Tax $mart Tip #14

Use construction tax planning any time you are building or renovating a large building. Consult with and engage a real estate CPA and tax engineering firm during the design and construction of the building to work in coordination with the architect, engineer and general contractor constructing the building. The name of the tax engineering firm that I use can be found at **www.taxsmartlandlord.com/myteam**

Chapter 15

GET A TAX CREDIT FOR FIXING UP OLDER OR HISTORIC BUILDINGS

Real estate landlords and developers can obtain a tax credit for making improvements to older or historic buildings that offset income tax dollar for dollar.

Any building owner or business owner who is renovating or redeveloping a historic building or non-historic building built before 1936 for income producing purposes can use this strategy.

The IRS wants to incentivize investors and business owners to preserve older buildings, especially those of historic significance. They offer tax credits to taxpayers who either directly rehabilitate or redevelop an older building, or invest in the rehabilitation of an older building.

There are two types of tax credits available –

- A rehabilitation credit equal to 20% of the cost of rehabilitating a historic building for use in operating a trade or business or for the production of rental income. These buildings can be either residential or non-residential in nature.
- A rehabilitation credit equal to 10% of the cost of rehabilitating a non-historic building built before 1936 for use in operating a trade or business, or for the production of rental income. These buildings must be non-residential, commercial, or industrial in nature.

Tax $mart Tip #15

There are other considerations related to the classification of renovation costs as either repairs or capital improvements. In order to qualify for the rehabilitation tax credit, the renovation costs must be classified as capital improvements and depreciated. There may be situations when the building owner would save more tax dollars classifying the parts of the renovations that qualify as repairs in order to be able to take the immediate tax deduction. This is a prime example of how tax strategies need to be tailored to obtain maximum benefit.

Chapter 16

GET A TAX CREDIT FOR DEVELOPING LOW INCOME HOUSING

Low income housing credits are available to developers and their investors as an incentive for them to build housing for low income families. These credits represent a dollar for dollar credit against income tax liabilities.

The government created these credits to act as an incentive for developers to build affordable rental properties. The developers can sell the credits to investors to raise the capital necessary to build these properties. This results in the developer having to borrow less money to build the housing which allows them to offer more affordable rents to low income families.

In order for a property to qualify for consideration for low income housing credits, it must be:

- A residential rental property.
- Meet one of two possible low income occupancy threshold requirements.
- Restrict the amount of rent in low income units.
- Operate under the rent restrictions for 30 or more years.

A developer (or the investors he sells the credits to for providing cash for the project) receives the following low

income housing tax credits if they qualify:

- 70% of the qualified basis of new buildings if they are not federally subsidized including improvements. These buildings can be new construction or renovated properties that are being converted from commercial (non-residential) to residential use. The credit is spread out equally over a 10 year period.
- 30% of the qualified basis of a new building that is federally subsidized or an existing building that is not federally subsidized. The credit is spread out equally over a 10 year period.

Tax $mart Tip #16

Developers of low income residential housing can receive tax credits that can be used to offset income tax dollar for dollar or can be sold to investors in order to finance the property.

Chapter 17

USE A SELF-DIRECTED IRA TO BUY REAL ESTATE

Landlords can purchase rental properties using the money in their retirement account as an alternative investment to generate tax deferred or tax free wealth.

This is important because it offers landlords an opportunity to use retirement funds to purchase real estate which can offer a higher return on investment than traditional stocks, bonds, or mutual funds. It also allows landlords to sell the properties in their retirement account and defer or eliminate the tax consequences.

Anyone with a retirement account who wants to invest in real estate is a candidate for this strategy. Obviously, the more retirement savings you have, the more opportunities for investment. In addition, it is possible to use a Roth IRA to invest in real estate also.

There are many advantages to using this strategy such as:

- Gains on sale are tax free
- Net rental income is tax free
- No mandatory property holding period to get beneficial tax treatment
- Your IRA can borrow money to purchase properties but it must be non-recourse debt

- You can earn a larger rate of return on your retirement investments

You can use this strategy to purchase all kinds of rental real estate and related real estate investments including:

- Land
- Residential homes (but not for you to live in!)
- Commercial properties – office buildings, shopping centers, industrial buildings
- Apartment buildings
- Condominiums
- Mobile homes
- Real estate notes
- Real estate purchase options
- Tax lien certificates
- Tax deeds

You can use the following steps to purchase a property in your self-directed retirement plan:

1. Set up and fund a self-directed IRA. You can rollover dollars from other retirement plans as well as contributions to fund your self-directed IRA
2. Set up a self-directed IRA LLC to give you checkbook control of your retirement funds. Your retirement account owns the LLC.
3. Identify an investment property
4. Purchase the investment property and hold title in the name of the self-directed IRA LLC.
5. All rental income must be deposited to the IRA LLC

bank account and all expenses paid from the same account. No commingling with personal funds is allowed.

6. All net income and/or gains from sale flow to your self-directed IRA tax free. In a traditional self-directed IRA, you will not pay income taxes until you begin to draw the money out of the retirement account after you retire. In a Roth self-directed IRA, you never pay income taxes, as all of the retirement account is considered after tax dollars.

Tax $mart Tip #17

Buying real estate in a self-directed IRA is a great tax strategy for building wealth that is tax-deferred. There are many rules related to how to do this so make sure you consult with a real estate specific CPA familiar with how to make this strategy work for you. The name of the company that sets up self-directed IRAs for my clients can be found at www.taxsmartlandlord.com/myteam

Chapter 18

USE A SELF-DIRECTED ROTH IRA TO BUY REAL ESTATE

A Roth IRA is a type of retirement plan where the contributions made to the plan are not deductible for tax purposes but the income from the plan assets is tax-free and any distributions outside the plan are tax-free.

A real estate investor can use a Roth IRA to purchase an income property and never pay a dime in taxes on the income generated from the property or on the capital gain generated when the property is sold.

A Roth IRA differs from the traditional IRA discussed in the previous chapter. While the rules for self-direction and investing in real estate are the same, the primary difference between a Roth IRA and a Traditional IRA is that:

- Contributions to a Traditional IRA are tax deductible, contributions to a Roth IRA are not.
- Distributions from a Traditional IRA are taxed upon distribution, distributions from a Roth IRA are not, with minor exception.

You may convert a traditional IRA to a Roth IRA but you will have to pay the taxes on the total amount of the conversion in the year you convert it. This assumes that all the contributions you made to the traditional IRA were tax

deductible.

The benefit of doing this is that once you pay the tax on the conversion amount, the balance grows tax-free forever and you never pay another dime in taxes again even when you distribute the money to yourself.

The advantages of a Roth IRA are:

- No mandatory minimum distributions at age 70 ½ like a Traditional IRA
- You can make contributions to a Roth IRA after age 70 ½ if you still have earned income
- You can take penalty free distributions under age 59 ½ for death, disability or for purchasing your first home
- All distributions are tax free including the money you make from buying, operating, and selling a rental property.

The disadvantages of a Roth IRA are:

- You are taxed when you convert a traditional IRA to a Roth IRA
- You cannot distribute funds penalty free for five years from the date of the original contribution to the Roth IRA
- You cannot take distributions prior to age 59 ½ unless they qualify for one of the exemptions noted above.

Tax $mart Tip #18

Buying real estate in a self-directed Roth IRA is a great tax strategy for building wealth that you never have to pay taxes on. There are many rules related to how to do this so make sure you consult with a real estate specific CPA familiar with how to make this strategy work for you. The name of the company that sets up self-directed Roth IRAs for my clients can be found at www.taxsmartlandlord.com/myteam

Section 3

Tax Strategies When Holding Real Estate

Chapter 19

SAFEGUARD YOUR PROPERTY EXPENSES

Safeguarding your property deductions by maintaining the proper type of documentation and records in an organized fashion is the key to maximizing your tax savings and avoided the dreaded IRS audit.

When you own a rental property, there will be expenses that must be paid to finance, hold, and maintain the property in good condition. It doesn't matter whether the property is a shopping center, office building, residential apartment, or a single family house; the goal is to generate cash flow without paying income taxes.

The expenses paid need to be tracked in your record keeping system, and proper back-up documentation kept so that they are tax deductible. As a general rule of thumb, you should be keeping all of your back-up documentation for three years from the date you file your income taxes, and copies of tax returns for seven years from the date you file.

Typical Property Expenses and How to Safeguard Them

The following is a list of typical expenses that you will incur as an owner of a rental property:

- Mortgage interest – interest payments made to a bank or other lender for the purchase and renovation of the property.

- Real estate taxes – property taxes paid to local government for services.
- Property insurance – payments made to insurance companies for protection against damage and liability.
- Utilities - payments for oil, gas, electric, water, cable and internet for property if not paid by tenant.
- Advertising – costs of advertising to obtain tenants for property.
- Cleaning and maintenance - the cost of the everyday maintenance of the property including cleaning, landscaping, snow removal and other tasks performed on a regular basis.
- Leasing commissions - the cost of paying real estate agents to find tenants for the property. These commissions are amortized and deducted based on the term of the lease associated with the commission.
- Professional fees – the cost of paying attorneys and accountants for necessary legal, accounting, and tax work related to the operations of the property.
- Property management – the cost of paying an outside company or individual to manage the operations of the property.
- Repairs – the cost of making repairs to the property as necessary to keep the building systems in operational order.
- Office supplies – the cost of paper, toner, and other supplies necessary to operate the property.
- Surveys, appraisals, title checks and property inspections – the costs associated with necessary real estate services when purchasing, refinancing or selling a property.

- Depreciation – the systematic allocation of the real property portion of the purchase price of the property and the related improvements made to the property, expensed annually over the useful life of the property (27.5 years for residential rental property, 39 years for commercial property).
- Amortization – the systematic allocation of loan costs related to property financing over the term of the loan.

Tax $mart Tip #19

A complete checklist of deductible property expenses and the related documentation required to safeguard your deductions against an IRS tax audit can be found in the "Tax Smart Landlord" kit available for purchase at www.taxsmartlandlord.com

Chapter 20

SAFEGUARD YOUR OFFICE AND ADMINISTRATIVE EXPENSES

Landlords can safeguard their office and administrative expense deductions from an IRS tax audit by maintaining the proper type of documentation and records in an organized fashion.

When you own a rental property, there will be expenses that must be paid that are not direct property expenses, but expenses that relate to the administration of the property and the office functions of managing the property. It doesn't matter whether the property is a shopping center, office building, residential apartment, or a single family home; the goal is to generate cash flow without paying income taxes and these types of expenses are deductible against your rental income.

The expenses paid need to be tracked in your record keeping system and proper documentation kept for purposes of backing up your expenses so that they are tax deductible. As a general rule of thumb, you should be keeping all of your back-up documentation for three years from the date you file your income taxes and copies of tax returns for seven years from the date you file.

The following is a list of typical expenses that you will incur as an owner of a rental property:

- Smart phones, tablets, and other technology – the cost of the actual phone or tablet plus the cost of the monthly fees can be deducted to the extent of business use percentage.
- Office telephone & internet – the cost of your office landline and internet service related to the management and operation of your landlord business.
- Office supplies – cost of paper, toner, staples, pens/ pencils and other office supplies used in the operation of your landlord business.
- Computers and other office equipment – purchase price and installation cost of computers, copier, fax machine and other office equipment. The cost of these items are capitalized as fixed assets and depreciated over 5 years.
- Computer training – cost of being trained to use computer or specific computer software for purposes of accounting for operations of your properties or making management more efficient or effective.
- Office rent – cost of office space used for management of rental properties, meetings with tenants, contractors and other service providers. If you operate your landlord business from an office in your home, you can take the home office deduction.
- Office furniture – purchase price and installation cost of desks, chairs, bookcases, tables and other furniture items. The cost of these items are capitalized as fixed assets and depreciated over 7 years.
- Business related classes and seminars – purchase price and travel related expenses to classes and seminars

to enhance your management or operations skills in running your landlord business.

- Membership dues and subscriptions to publications – cost of dues to real estate related associations and cost of subscriptions to real estate related publication including internet based organizations or publications.
- Marketing and promotional items – cost of business cards and other promotional items for purposes of purchasing or selling properties and obtaining outside investors or private lenders for your landlord business.
- Postage – cost of mailing invoices to tenants, payments to vendor, and other mailings related to acquisition, management, or sale of your rental properties.
- Bank charges – service fees charged by bank for checking account
- Meals and entertainment – costs associated with providing meals and entertainment for prospective tenants, sellers, investors, lenders, and service providers

Tax $mart Tip #20

A complete checklist of deductible office and administrative expenses and the related documentation required to safeguard your deductions against an IRS tax audit can be found in the "Tax Smart Landlord" kit available for purchase at www.taxsmartlandlord.com

Chapter 21

TAKE THE HOME OFFICE DEDUCTION

Landlords may deduct a percentage of their house expenses if they run their rental property business from a dedicated office in their personal residence.

This is important because it allows you to deduct a percentage of your household expenses that you have to pay anyway, but that would normally not be deductible unless you are running a business from your home.

Expenses attributable to a home office deduction include:

- Homeowners insurance
- Utilities – electric, water, gas, oil and wood
- Cleaning
- Maintenance
- Repairs
- Depreciation

The deductibility of these expenses is based on the business use percentage of the home.

In addition, all costs related specifically to the decoration and furnishing of the home office are deductible including painting, furniture, area rugs, lamps, book shelves, flooring, other decorative items and office supplies.

Your home office deduction is based on the ratio of square footage between the actual office and the entire personal residence. It is calculated by dividing the square footage of the office by the square footage of the entire personal residence to come to a percentage of business usage.

Tax $mart Tip #21

Taking the home office deduction requires good record keeping. In order to calculate the home office deduction you would first keep a spreadsheet of household expenses by month. A format for this spreadsheet can be found in the "Tax Landlord" kit available for purchase at www.taxsmartlandlord.com

Chapter 22

TAKE THE MILEAGE ALLOWANCE ON YOUR AUTO EXPENSE

Rental property owners may deduct their automobile usage for any miles driven to manage their properties, look at potential properties for purchase, and for errands related to the management, purchase, or sale of the properties.

The business use of your automobile for the management of your rental real estate business is a substantial deduction, especially for active investors and real estate professionals. It allows you the opportunity to deduct expenses related to your automobile that would not ordinarily be deductible. It requires specialized record keeping in order to safe-guard the deduction.

Expenses attributable to the automobile deduction include:

- Fuel
- Insurance
- Repairs and maintenance
- Tolls
- Parking
- Registration
- Lease payments
- Interest on auto loans
- Personal property taxes on auto

- Depreciation

The deductibility of these expenses is based on the business use percentage of the auto.

There are actually two methods for determining what your automobile deduction would be.

- Method #1 involves tracking your business miles versus your total miles driven, calculating a business use percentage, and applying that percentage to the actual costs incurred to operate the vehicle.
- Method #2 involves tracking your business miles and applying the IRS's standard rate per mile to the amount of business miles driven to calculate the deduction. The current standard IRS mileage rate for 2014 is 56 cents per mile driven.
- You would compare the deduction calculated using both methods and deduct the higher one. For purposes of practicality, method #2 will usually always result in the higher deduction unless you have incurred high repair bills.

Tax $mart Tip #22

Like all tax strategies, taking the automobile deduction requires good record keeping. In order to calculate the automobile deduction you would first keep a spreadsheet of daily/weekly business driving. To calculate total miles, I recommend an odometer reading on January 1 and another at year end December 31. A format for this spreadsheet can be found in the "Tax Smart Landlord" kit available for purchase at www.taxsmartlandlord.com

Chapter 23

PROTECT YOUR DEDUCTIONS BY FILING 1099s

Landlords can safe-guard their deductions for repairs, interest and other services by filing Form 1099 annually.

One of the big issues I run into with landlords and real estate investors is failure to file 1099s for their independent contractors and service providers. If you fail to file form 1099 for any of these independent contractors or service providers, you risk the IRS disallowing the deduction for amounts paid for repairs, or services.

Landlords who pay an individual, sole proprietorship, LLC or partnership over $600 for repairs, interest, or other services must send that person or entity a Form 1099. For real estate investors, this means sending a 1099 to your contractors, handyman, property manager, and any other person or company who provides services to your business. In addition, you are required to send 1099s for mortgage interest paid to private investors.

If you fail to file form 1099 for any of these items, you risk the IRS disallowing the deduction for amounts paid for the services or loan.

You can get the information necessary to fill out Form 1099 by having every contractor and service provider fill

out a Form W-9. This information includes the:

1. Name of person or company
2. Address of person or company
3. Federal employers identification number (FEIN) or social security number

Tax $mart Tip #23

Make sure you file your Form 1099s every year to safeguard your tax deductions for repairs and services. You should make every person/entity that provides your business with services fill out a Form W-9 when you hire them and BEFORE you write them a check.

Chapter 24

KNOW THE DIFFERENCE BETWEEN A REPAIR AND AN IMPROVEMENT

Changing tax laws that went into effect for tax years starting January 1, 2014 created new rules regarding the classification of repairs versus capitalized improvements for buildings.

Repairs are expenses immediately in the year they are incurred and paid for. Capital Improvements are added to the cost basis of the property and depreciated over their useful life (27.5 years for residential property, 39 years for commercial property). This is a huge difference in tax benefit.

The new tax laws will create both opportunities and pitfalls for building owners. The new IRS regulations are good news from the standpoint that:

- they allow for a better, more lenient definition of repairs
- allow landlords to achieve increased cash flow resulting from lower income taxes
- they create opportunities to reclassify items booked as improvements in prior years as deductible repairs in 2014 retroactively
- They create an opportunity for business losses to be created related to the abandonment of building components discarded during renovation.

The new IRS regulations are bad news from the standpoint that:

- they are complex
- the classification of repairs vs improvements requires careful consideration of the facts and circumstances related to the work being done
- they place the burden of proof for compliance and record keeping on the taxpayer
- they require the taxpayer to file "change in accounting method" forms and make necessary elections in 2014 to comply with the new rules
- they require specialized services be performed in order to take advantage of the repair or abandonment deductibility

The IRS has stated new guidelines that define what constitutes a repair and what constitutes an improvement. They are as follows:

A repair –

- Keeps property in efficient operating condition
- Restores a property to its previous condition
- Protects the property with routine maintenance
- Includes all minor "incidental" materials and supplies less than $200

An improvement –

- Puts the property in better operating condition
- Restores the property to "like new" condition
- Includes the addition of new property components

- Upgrades or modifies the property
- Extends the useful life of the property
- Adapts the property to a new use

Tax $mart Tip #24

Landlords need to know the difference between a repair and an improvement so that they can maximize the deductibility of the work they do on their rental units. Consulting a real estate specific CPA prior to beginning work with a plan of what work will be done to the property can result in large tax savings.

Chapter 25

RECLASSIFY PRIOR YEAR IMPROVEMENTS IN 2014

An opportunity exists to “look back” at items classified as capitalized improvements in 2012 and 2013 and reclassify them as repairs in 2014 in order to get the benefit of the immediate expensing.

The new repair vs capitalized improvement laws allow landlords to reclassify items as deductible repairs in 2014 if they qualify under the new standards. This gives the landlord a deductible expense that may result in immediate tax savings in 2014 instead of the gradual tax deduction of depreciating the improvements over either 27.5 or 39 years.

On September 16, 2013, the Internal Revenue Service enacted new regulations regarding the classification of repairs made to rental properties as either deductible repairs or capitalized improvements. The new rules replace the temporary regulations enacted in 2011 which were effective for tax years beginning January 1, 2012. The new permanent regulations (part of IRS Code Section 263(a)) are effective for tax years beginning January 1, 2014.

There are several types of repairs that have historically been classified as improvements by tax preparers that may qualify as repairs such as:

- Roof repairs and replacements
- Replacing lighting
- Repaving parking lots
- Replacing doors and windows
- Resurfacing interior or external floors
- Interior and exterior painting
- Replacing HVAC units

If you have done these types of work to your buildings in 2012 or 2013 and your tax preparer classified them as capitalized improvements and is depreciating them, you can reclassify them as repairs in 2014 and take a full deduction on them.

In order to do so, you will have to file a Form 3115, Change in Accounting Method form with your 2014 tax return.

Tax $mart Tip #25

Review the depreciation schedules on your rental properties for 2012 and 2013 to see if you CPA capitalized improvements to your rental properties in those years. If so, you should contact me at **ted@lanzarocpa.com** to discuss whether this tax strategy can help you save thousands of dollars in taxes for 2014 and beyond.

Chapter 26

TAKE ADVANTAGE OF ENERGY EFFICIENT TAX DEDUCTIONS

Renovations to a commercial (residential over 4 units or non-residential) rental property that qualifies for a 179D energy certification can produce additional tax deductions over and above the cost of the renovations.

The government is offering incentives to commercial building owners whose buildings meet the energy savings standards required by the Department of Energy. There exists an opportunity to save energy and get a huge tax deduction as a result of proper construction planning to save energy.

The deductions vary by type. Here are the various types of deductions:

- Maximum Deduction – $1.80 per square foot = 50% reduction in total annual energy and power costs (compared to a reference building that meets the minimum requirements of ASHRAE Standard 90.1-2001) not to exceed the amount equal to the cost of energy efficient commercial property placed in service during the taxable year.
- Partial Deduction – $0.60 per square foot / per system for reduction of energy consumption through building envelope, HVAC, and lighting
- Partial Deduction (interim lighting) from $0.30 to

$0.60 per square foot = 25 – 40% reduction in lighting power density (50% in the case of warehouses)

The following building types qualify for the deduction:

- Commercial buildings of any size
- Residential rental apartment buildings that are four or more stories
- Commercial energy renovations

The requirements vary by the type of item replaced to create energy savings. They are as follows:

Lighting

Lighting is the only component that can partially qualify for the deduction. Depending on the reduction of Lighting Power Density (LPDs), the owner/designer can qualify from $0.30 – S0.60 per square foot. Lighting is dependent on square footage, building type, bi-level switching, and energy consumption. There are also multiple ways for qualifying a property based on the code revisions.

HVAC

A project must have new equipment installed which can include air or water cooled chillers, rooftop units, PTAC units, geothermal systems, or high-efficiency unit heaters. Certain options will enhance your property's likelihood of qualifying.

Building Envelope

The building envelope can be the most difficult system to qualify in a renovation/retrofit. Typically if at least two of these items have been upgraded it may qualify. These systems include: windows, roofing improvements, window film or tint, doors, and wall-roof or floor insulation.

Unfortunately, this is another of the tax incentives which expired as of December 31, 2013. The original tax law applied to properties placed in service (New Construction or Renovation) after December 31, 2005 but before January 1, 2014.

However, Congress extended the deduction to include properties placed in service in 2014 and there is pending legislation in Congress that would extend the tax break through December 31, 2016. As of the date of this writing, Congress had not yet passed the extension through December 31, 2016.

Tax $mart Tip #26

If you did this type of renovation work in 2014 or prior and did not take these deductions, have a 179D review completed by a licensed tax engineering firm and get a report that certifies the deduction. The name of the tax engineering firm I use for my clients can be found at www.taxsmartlandlord.com. Keep an eye out for an extension of this deduction through 2016.

Chapter 27

USE LLC'S & LP'S TO AVOID RENTAL PROPERTY AUDITS

Using a business entity like a Limited Liability Company (LLC) or Limited Partnership (LP) not only provides asset protection for your rental properties, it reduces your chance of being randomly audited by the IRS.

An IRS audit is akin to a financial colonoscopy. They are no fun, require you to provide a lot of information, and will waste a lot of your time and money. This book is all about tax strategy and the records you need to keep to safe-guard your tax returns. An additional strategy is to use business entity types such as the LLC or LP that are audited by the IRS much less than your personal income tax return (Form 1040).

This strategy works because the IRS audits a much lower percentage of LLCs and LPs than they do personal income tax returns. When you report your rental income and deductions on your personal income tax return, you report them on a form called a Schedule E, which provides the IRS with a detail of your deductions.

The IRS uses this detail to compare your deductions with the national averages for deductions on other rental

properties of a similar nature. The IRS calculates a DIF (Discriminate Function System) score for your return. They audit the returns believed have the highest chance of being incorrect and therefore produce the largest amount of tax collected as a result of an audit. This is basically cost-benefit analysis – the IRS choosing to use its audit resources efficiently.

The IRS audits personal income tax returns at a higher rate because of the potential for additional taxes to be paid in. LLC and LP tax returns are flow-through returns which produce a form called a Form K-1 that provides each partner with their proportional share of income or loss that needs to be reported on the partner's personal income tax return. LLCs and LPs pay no income taxes. As a result, the IRS audits them at a much lower rate.

Tax $mart Tip #27

Proper entity structure is a must if you want to take maximum advantage of the IRS tax code. A bonus report included in the "Tax Smart Landlord" kit has a more detailed discussion of the advantages of entity structure for holding rental properties.

Chapter 28

MAKE NECESSARY ELECTIONS AS A REAL ESTATE PROFESSIONAL

In order to be treated as a real estate professional for purposes of deducting rental losses, there are specific elections that must be made when filing your personal income tax returns.

If you recall from Chapter 7, a real estate professional is someone who actually works substantially in the real estate business. In order to qualify as a real estate professional, there are certain criteria that must be met on an annual basis.

But, in addition to qualifying, you must make certain elections on your tax return in order to get real estate professional status. If you do not make these elections, you will get caught in an IRS tax trap, you will not get real estate professional status, and your losses may be disallowed.

What are those elections?

1. You must elect to be treated as a real estate professional.
2. You must elect to aggregate your properties into one real estate business.

Tax $mart Tip #28

You must make sure that your accountant makes the necessary elections every year to be treated as a real estate professional and to aggregate your real estate activities into one real estate business. I have included copies of sample real estate professional elections in the "Tax Smart Landlord" kit available for purchase at www.taxsmartlandlord.com

Chapter 29

PAY YOUR CHILDREN TO DO OFFICE AND PROPERTY WORK

Landlords may increase their property deductions by paying children to do office work or property maintenance on their income properties.

Paying your children for work done on your rental properties can increase tax deductions on your properties if you are an active investor or a real estate professional.

If you are like most parents, you are already giving your children money in the form of an allowance which is not tax-deductible. But, you can pay your children for work done. Here are some examples of work your children can perform:

At the office

- Filing
- Social Media Marketing (they are probably better at it anyway)
- Creating flyers
- Doing mailings
- Answering the office phone
- Cleaning office
- Any other office administrative functions

At the rental unit

- Cleaning rental units
- Cutting lawns at properties
- Shoveling snow at properties
- Gardening
- Painting

You are allowed to pay children of any age reasonable compensation for any tasks they can perform that are legitimate business functions you would have to pay someone else to do, or for tasks that produce income for the company.

There are many benefits to paying your children:

1. You are probably giving them money anyway. Teach them work ethic and deduct the amounts you are paying them.
2. You can set them up with an Individual Retirement Fund and make either a deductible contribution or non-deductible contribution with the money they earn.
3. If you set up self-directed retirement plans for them, you can make them investors in future rental properties purchased.
4. You can fund their college savings accounts with the money.

The compounding effect of an investment growing tax-free inside a retirement plan or college savings account should result in a nice accumulation of money for them as adults if you start early.

Tax $mart Tip #29

This is a great strategy to reduce your income taxes and put money away for your kids. Check with your tax professional regarding proper entity structure for taking this deduction and payroll tax filing compliance.

Chapter 30

TAX PLAN YOUR INCOME TO MAXIMIZE REAL ESTATE LOSSES

There are numerous tax strategies available for business owners that can help you minimize your business income, and therefore maximize your rental property losses.

This strategy works best for active investors who are also business owners. It can also work for active investors who are not self-employed. By determining how much earned income and potential rental losses you have in a given year, you can employ various tax strategies to reduce your ordinary income in order to maximize the deductibility of your rental losses.

The best way to determine if tax planning will help you in a given year is to:

- Figure out what your business income is as of November 30.
- Figure out what your employment income is as of November 30.
- Figure out what your rental losses are as of November 30.

Once you know this information, it is time to employ some tax strategies to help you maximize the amount of rental losses you can take against your earned income.

Once you have a handle on what your earned income and rental losses are, you will find that you are in one of the following situations:

1. Your earned income is way over the limit for deducting rental losses. Stop right here – this strategy is not for you.
2. Your earned income is slightly over the limit for deducting rental losses or your earned income is causing some of your losses to be phased out. For a married couple filing jointly, rental losses phase out between $100,000 and $150,000 of adjusted gross income. You can reduce your earned income by:
   - Purchasing and fully depreciating fixed assets for your business.
   - Prepaying expenses in December for the following year to reduce your business income.
   - Make a retirement plan contribution to reduce your earned income. Employees can make sure they are making the maximum 401K plan contribution to reduce their income from employment.
   - Deferring any income expected in December into the following year – payments from customers or bonuses from employers can be requested to be paid in January.
   - Make a contribution to a health savings account.

By using these strategies, you will reduce your earned income below $100,000 and avoid the phase out of the $25,000 of real estate losses you would get as an active investor.

3. Your earned income is below $100,000 but you are showing rental income instead of loss for the year. You can increase the amount of rental losses for the year by:
   - Prepaying your real estate taxes for the following year.
   - Making an additional mortgage payment on the property.
   - Making and paying for necessary repairs on the property prior to year end.
   - Purchasing a new rental property and taking accelerated depreciation on the 5 to 15 year assets.
   - Prepaying any other property related expenses prior to year end.
   - Prepaying any other office related expenses prior to year end.

These strategies would be especially helpful if you knew that the following year would bring higher income that would phase you out of your rental loss deductions.

Tax $mart Tip #30

Year–end tax planning to maximize the deductibility of rental losses is a strategy that can save you thousands of dollars annually on your taxes. Contact me at **ted@lanzarocpa.com** to determine whether this strategy will benefit you.

Chapter 31

OWN THE BUILDING YOU RUN YOUR BUSINESS FROM

Owning the building you run your business from can save you tax dollars if the business pays you rent.

Owning the building you run your business from has several advantages –

- It allows you to reduce the amount of self-employment or payroll taxes you pay annually (15.3% social security and Medicare tax including employer match portion).
- The depreciation on the building offsets all or a portion of the rent creating tax-free cash flow.
- It makes your business more valuable when you sell it.

Have your business pay rent to you or your rental entity for the use of the building you own. You must make sure that the rent that you pay is market rent (similar to what you would pay if you rented the building from someone else). Your rental entity pays the expenses of the building and gets a depreciation deduction which offsets the rental income.

Your business gets the deduction for the rent that you pay. Since you are able to deduct the rent, it reduces the amount of income you must pay self-employment tax on. If

you operate your business as a corporation, it saves you on the amount of payroll taxes and corporate income tax you have to pay.

Tax $mart Tip #31

Owning the building you run your business from works. Remember to set up a lease between your business and your rental entity. Make sure that the rent is actually paid every month and that the amount of rent is similar to the amount that would be paid to an outside party (market rent). Check with a commercial realtor to determine market rent in your area.

Chapter 32

FUND YOUR SELF-DIRECTED IRA/SEP FROM YOUR BUSINESS INCOME

Landlords with earned income from a trade or business can fund a deductible self-directed retirement plan contribution from their business and use it to purchase income properties.

Business owners have the ability to defer profits from their business by making deductible contributions to their retirement plan. There are a variety of options available to do this including self-directed plans that allow you to invest in real estate. The key is to figure out which retirement plan is best for you in order to both maximize tax savings and achieve your retirement income goals.

A landlord with earned business income can use this strategy to reduce income taxes by making a deductible retirement plan contribution. There are a variety of self-directed retirement plan options and each has an annual contribution limit.

Here are three basic self-directed retirement plan options and their respective contribution limit for tax year 2014 –

- Individual Retirement Account (IRA) – requires you to have earned income equal to or greater to the contribution amount. Maximum contribution for 2014

is $5,500 with an additional "catch up" contribution of $1,000 for taxpayers over 50.

- Elective Deferral Plan (401K) – requires you to have W-2 income equal to or greater than the contribution amount. Maximum contribution for 2014 is $17,500 with an additional "catch up" contribution of $5,500 for taxpayers over 50.
- Defined Contribution Plan (SEP) – requires you to have earned income. You can contribute 19.2% of your earned income with a maximum contribution amount of $52,000 in 2014.
- Non Deductible Individual Retirement Account (Roth IRA) – You can make contributions similar to an Individual Retirement Account except that they are non-deductible. The advantage is that you never have to pay tax on the income you earn inside the retirement plan as long as you keep it open for five years.

In addition, there may be income limitations on each of these plan types that could reduce the deductibility of the retirement plan contribution.

There are several ways to use this strategy to minimize your income taxes while maximizing your ability to use some of the other strategies in this guide such as:

- If you are an active investor, you can use retirement plan contributions to reduce your adjusted gross income and increase your ability to take rental losses.
- You can adjust the amount of deductible retirement plan contribution every year based on your taxable income via annual tax planning.

- You can convert your deductible self-directed retirement account dollars to a self-directed Roth IRA rollover account. You have to pay the taxes in the year of conversion but you get tax free treatment on all dollars earned in the account for the life of the account.
- You can buy real estate with your retirement account and not pay income taxes on your rental income or capital gains until you take the money during retirement.

Tax Smart Tip #32

Retirement plan contributions are a great way to reduce your business income and fund your real estate portfolio. The name of the company I recommend to my clients for setting up self-directed retirement plans can be found at www.taxsmartlandlord.com/myteam

Section 4

Tax Strategies
When Selling Real Estate

Chapter 33

KNOW WHAT YOUR GAIN ON SALE IS

Rental property owners need to know how to calculate the gain or loss on the sale of a property in order to know what the tax effects of the sale are.

There are a handful of tax strategy options available to landlords who want to sell their property. In order to know which of these strategies is best for a given sale, you need know whether you have a gain or loss on the sale and how much.

You should evaluate the gain or loss on the sale of a property at the time you receive an offer you may be interested in and PRIOR to selling the property.

The calculation of the gain on the sale of a rental property is formulaic. A spreadsheet for calculating the gain on a sale of a property can be found in your tax tools.

Total Selling Price

The calculation starts with knowing the total selling price. Generally speaking, this is the offer price and can include cash to be received, notes receivable, and the fair market value of any other items received as consideration as part of the sale.

Selling Expenses

Selling expenses are the second piece of the calculation and include all of the expenses of the sale including real estate commissions, transfer taxes, legal fees, title insurance, deed preparation and any other expenses required to close to sale.

Total Selling Price less Selling Expenses = Net Selling Price

Adjusted Cost Basis

Once you know the net selling price, you will need to determine the adjusted cost basis of the property. The adjusted cost basis of the property is determined by the purchase price of the property plus any capitalized improvements made to the property during the time of ownership, less the depreciation taken on the property over the time period it was a rental.

Original Purchase Price + Cost of Capitalized Improvements – Accumulated Depreciation Taken = Adjusted Cost Basis

Once you know the Net Selling Price and the Adjusted Cost basis, you can do this simple mathematical calculation:

Net Selling Price – Adjusted Cost Basis = Gain (loss) on sale

Realized Gain

But wait, there's more…

If you are not a real estate professional who can deduct all of their rental losses every year, you may have losses

from previous years that you could not deduct in those years. Those losses are called passive loss carryovers. These passive loss carryovers can be found on your personal income tax return and are deductible in the year you sell the property against the gain on sale. The calculation is as follows:

Gain (Loss) on Sale – Passive Loss Carryovers = Realized Gain (Loss) on Sale

It is from this number that you calculate the income tax or capital gain tax that will have to be paid if you sell the property.

Tax Smart Tip #33

Knowing how to calculate the gain on sale allows you to evaluate whether or not to implement a tax deferral strategy for the gain or simply pay the taxes due. A spreadsheet for calculating the realized gain on the sale of property is included as part of the "Tax Smart Landlord" kit available for purchase at www.taxsmartlandlord.com

Chapter 34

USE THE PERSONAL RESIDENCE EXCLUSION TO AVOID TAX

Current tax laws allows for an exclusion of gain on the sale of a personal residence subject to certain criteria.

An exclusion of gain means that you do not have to pay taxes on a gain up to a certain amount. For single individuals, the gain exclusion is $250,000 and for married individuals filing jointly, the gain exclusion is $500,000. This means a married couple can sell their personal residence for up to $500,000 more than their cost basis and never pay a dime in income taxes.

In order to use the full amount of the gain exclusion on the sale of your personal residence, you must have lived in that residence for two of the last five years. A partial gain exclusion may be used on the sale of a personal residence if you lived in it for less than two years but had to sell because of changes in employment, illness or other unforeseen circumstances.

There are a number of ways to use this strategy as a real estate investor and landlord. This assumes you are flexible as to your personal housing.

1. You can buy a bargain home in an area where prices

are rising and sell it in two years. Any gain under the exclusion amount would be tax free income.

2. You can live in a house for two years, rent it for three years and sell in within the five year period. Any gain under the exclusion amount would be tax free income.

3. If you have a single family rental property that is fully depreciated and would have a large capital gain, you can move into it for two years. Any gain under the exclusion amount would be tax free income.

4. In the case of a two-family house, you could live in each unit for two years within a five year period, rent the other half of the house, and sell it within five years. Any gain under the exclusion amount would be tax free income.

Tax $mart Tip #34

Use the personal residence exclusion to avoid paying capital gains taxes on single family or multi-family rentals.

Chapter 35

USE A SECTION 1031 EXCHANGE TO DEFER TAXABLE GAIN

When a landlord sells an income producing property, he may defer the gain on the sale of the property and the related capital gains tax by purchasing a "Like Kind" property of greater or equal value subject to a series of complex rules.

The Section 1031 exchange is the greatest tax tool for building wealth for real estate investors that exists today. The easiest way to build wealth is to not pay any taxes on the growth of your investments as they increase in value. Section 1031 allows you to do this, thus accelerating the rate that your wealth grows.

A real estate investor should use a section 1031 exchange when they want to sell an income producing property (rental property) they own and they want to purchase another property of equal or greater value in order to avoid paying the capital gains tax.

Real estate investors cannot use section 1031 exchanges to defer gains on properties that were held for personal use or on properties held primarily for resale. Buying, rehabbing, and flipping a property is an example of a property held primarily for resale that would not qualify for section 1031 treatment.

A Like-Kind exchange is basically just that. The landlord sells one property and purchases another in accordance to the section 1031 rules. This is essentially exchanging one property for another. For purposes of real estate exchanges, the properties sold and purchased have to be held for business or investment purpose but do not have to be identical. For example, you can exchange a residential apartment building for a commercial shopping center or an industrial warehouse for a self-storage facility.

In a deferred Section 1031 exchange, the building owner must:

- Identify a replacement property to purchase with 45 days of the sale of the old building.
- Complete the purchase of the new building with 180 days of the sale of the old building.
- Use a qualified intermediary to hold the proceeds of the initial sale of the property until the new property is purchased. In addition, the qualified intermediary prepares the necessary paperwork to structure the exchange transaction.

Tax $mart Tip #35

This is by far my favorite tax strategy for real estate property owners, and the one with the greatest wealth building potential. When you are selling a property that you have held as an investment, planning is essential. To implement an exchange and safeguard it from audit, you should plan well in advance and consult a tax professional like myself who specializes in real estate investments before the sale occurs. The success of using the Section 1031 strategy depends on the transaction being structured precisely according to the rules.

The name of the qualified intermediary firm I recommend to clients can be found at www.taxsmartlandlord.com/myteam. A checklist for successfully implementing a Section 1031 exchange is part of the "Tax Smart Landlord" kit available at www.taxsmartlandlord.com

Chapter 36

USE AN INSTALLMENT SALE TO DEFER T AXABLE GAIN

When a landlord sells an income producing property, he may defer the gain on the sale of the property and the related capital gains tax by giving the buyer a purchase money mortgage (an installment note payable) and receiving the proceeds of the sale on a periodic basis (usually monthly) in the form of a mortgage payment.

An installment sale is another tax tool for building wealth as a real estate investor. It allows you to defer the payment of taxes over the term of the installment note payable. Since the amount of capital gain tax is based on the amount of the payments received, the installment sale allows you to structure your payments to avoid additional surcharge taxes on taxable income over $250,000 annually.

A real estate investor should use an installment sale when they want to sell an income producing property (rental property) they own and they do not want to purchase another property but want to maintain a stream of income from the property and defer capital gains taxes.

Real estate investors cannot use installment sales to defer gains on properties that were held primarily for resale. Buying, rehabbing, and flipping a property is an example of

a property held primarily for resale that would not qualify for installment sale treatment if the investor is classified as a dealer.

When an income property is sold at a gain, the difference between the original purchase price of the property and the selling price is considered to be a capital gain. If no tax planning is done, the capital gain tax is all due for the year of the sale.

However, using an installment sale, the seller pays capital gains as they receive payments.

The advantages of using this strategy are four-fold:

- Easier to sell the property during a credit crunch.
- Interest income can be substantial and raises the amount of dollars received on the sale of the property.
- The capital gain on the property is split and partially deferred over a longer period of time resulting in lower total taxes paid assuming no changes in capital gains rates over the period of the loan.
- If the buyer defaults on the mortgage, the seller can foreclose, keep the payments received including the down payment, and resell the property

Tax $mart Tip #36

Use an installment sale when you want to defer capital gains taxes but do not want to purchase another building. You get the cash flow from the mortgage payment without the responsibility of managing the building.

Chapter 37

REDUCE TAXES ON GAINS WITH UNUSED PASSIVE LOSSES

When an income producing property is sold, any passive losses that have not been deducted in prior years immediately become deductible in the year the property is sold.

It is important to remember to account for unused passive losses and to deduct them in the year the property is sold. The passive losses deducted in the year of sale may offset earned income without limit and restriction, and therefore are quite valuable.

Passive losses on rental properties can be non-deductible in the current year because of income restrictions on losses or because the property owner chooses to not actively manage the property. When this situation occurs, the non-deductible passive losses are accumulated and carried over to future years.

In the year you sell the income producing property, all of the passive losses become deductible in the current year. This is valuable because the losses offset any capital gains on the sale and/or any income earned in that year.

Tax $mart Tip #37

There are a lot of property owners who own multiple rental properties and aggregate their rental income and expenses on their tax return instead of reporting the rental income and expenses for each property separately. If you are a passive investor or someone whose income prevents them from deducting rental losses, then it is imperative that you report your properties separately on your personal or entity tax return in order to take advantage of the passive loss carryovers when you sell an individual property.

Chapter 38

DON'T SELL-PASS ON PROPERTY TO HEIRS UPON DEATH

This strategy is an alternative to selling your property if it has large capital gain potential. Instead of selling, you transfer the property to your heirs upon your death.

This strategy is powerful because you can completely avoid paying any capital gains taxes ever on the increase in value of an income producing property over a period of time.

Anyone who has built a real estate portfolio with a total value less than five million dollars can avoid paying capital gains on the appreciation of their income producing property by transferring it to their heirs upon death. It should be noted that individual states may also have estate tax limits which are lower than the federal limit.

Current tax law states that when a property is transferred upon the death of the owner, the heir receives a "step-up" in the cost basis of the property. A "step-up" means that the cost basis of the property becomes the fair market value of the property as of the date of the death of that person, no matter what the owner paid for the property or how much depreciation was taken on the property during the time the dead person owned the property.

The Federal limit for transferring assets upon death is $5,340,000 in 2014 and $5,430,000 in 2015. State limits may vary but typically state rates are much lower than the IRS estate tax rates.

This means that a property owner can leave up to 5.4 million dollars of assets to his heirs without paying a dime in estate or income taxes. The inheritance is not taxable to the heirs until they sell the assets. If planned properly, the heirs will never pay a dime in taxes when they sell either.

Tax $mart Tip #38

This is an awesome strategy but estate planning is complex – it must be planned out using the services of a qualified estate attorney and CPA. Please consult professionals in this area to implement this strategy. If done correctly, it can sae you hundreds of thousands, even millions, of dollars.

Chapter 39

USE A LEASE-OPTION TO DEFER CAPITAL GAINS

Lease-optioning your income producing property instead of selling it is a great strategy that doesn't trigger capital gains tax because the property has not been sold.

The lease-option is another tool that income property owners can use as an alternative to selling the property when they are tired of managing the property.

Any owner of income producing property who has large capital gain potential on their property, but want to defer the taxes for a period of time while maintaining some income stream from the property, should consider this strategy.

A lease-option is simply a lease with an option to purchase the property at some later date. Instead of selling the property, the owner leases it to someone who wants to manage the property, collects rent on a master lease, and allows the investor leasing the property to operate the property.

There are several advantages of using the lease option strategy –

- No taxable capital gains because no sale has occurred.
- No management responsibilities – the leasing investor operates the property.

- Owner maintains a large percentage of the net cash flow after property expenses and receives an up-front payment for the purchase option which is non-taxable until the expiration of the purchase option.

This is how it works. The owner of the property leases the property to another investor under a master lease and gives the investor the option to purchase the property in exchange for a sum of money or other consideration. Typically, the purchase option is for a given price over a certain time period.

The investor leasing the property under the master lease is now responsible for renting out the property and paying the expenses of the property including the rent due on the master lease. The reason the investor will do this is because they collect a spread of dollars between the rents they collect and the amount they pay out. The leasing investor also typically builds up credits for each payment made towards the ultimate purchase of the property.

Ultimately, the investor leasing the property exercises the purchase option and buys the property or allows the option period to run out and they lose their option payment. If the option is not exercised, the owner keeps the option payment and pays ordinary income tax on the amount received in the year the option runs out.

Tax $mart Tip #39

Use a lease-option strategy instead of selling the property to defer capital gains and maintain cash flow from the property without management headaches.

About The Author

Ted Lanzaro is a highly recognized and respected Certified Public Accountant, real estate investor, real estate broker, author and speaker. He is the founder of Lanzaro CPA, LLC located in Cheshire, Connecticut, a boutique CPA firm specializing in accounting and taxation for the real estate industry. For the past 24 years, he has helped thousands of real estate business owners, entrepreneurs and investors all over the United States implement cutting edge tax strategies that save them thousands of dollars annually on their taxes.

Mr. Lanzaro has made numerous appearances on various television and radio shows including Fox Business News to discuss current tax topics. He has also contributed to articles that appeared in Investor's Business Daily, the Wall Street Journal and a variety of other local Connecticut newspapers.

Mr. Lanzaro is the author of "The Tax Smart Landlord" and the "Tax Smart Landlord" toolkit as well as over 100 articles on taxation for the real estate industry-specifically for investors, landlords, "flippers", and developers.

Ted is a sought after speaker and has spoken all over the United States to groups of real estate investors and business owners on real estate taxation topics.

For more information about CPA Ted Lanzaro, you can visit his website at www.tedlanzaro.com

Bonus Report

Evaluating Rental Real Estate Purchases

The ability to evaluate and purchase good investment real estate is a must-have skill for real estate investors. I would love for you to have my special bonus report "Evaluating Rental Real Estate Purchases" and my "Rental Property Evaluator Spreadsheet" that will help you calculate the cash flow, cap rate, and cash on cash return on investment for every property you buy or currently own. It is available for you to download at **www.taxsmartlandlord.com**

"The Tax Smart Landlord is great information all investors and landlords should have in their toolbox! Your chapters on using self-direct IRA's to invest in real estate will not only help investors saves tax dollars but gives investors another way to fund their property purchases. Great job!

David Hollis, Real Estate Investor, Stratford, CT

"I was impressed by the knowledge of both real estate investing and taxation revealed in "The Tax Smart Landlord". Most resources only cover one or the other. You covered both in great detail! It became clear quickly that you really understand my business and the IRS tax savings tips and tools in the kit are a must have for any landlord looking to keep Uncle Sam out of his pocket. This book is well written and informative – Thanks for being a resource to your fellow investors!"

Paula Licitra, MPT Investments, LLC, Torrington, CT

"Hey Ted, your "Tax Smart Landlord" book is really informative! Tip #38 about using estate planning to avoid capital gains taxes by passing the properties to heirs is right on target. This strategy helped one of our clients avoid hundreds of thousands of dollars in capital gains taxes. Thanks for this guide. Can't wait to see what you roll out next!"

Eric Green, Tax Attorney, New Haven, CT

"The Tax Smart Landlord is very well done and offers a comprehensive look at tax strategies for real estate investors. Great job presenting information in an easy-to-read-manner. I recommend it to any investor who wants to maximize their annual income tax savings. Thanks for writing this, Ted. The market has needed it for a while!"

Cindy Blumenfeld, Director of Business Development
Engineered Tax Services, West Palm Beach, Florida

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