The Insider Scoop - - -Tax Reporting for Real Estate Activities©

(A Life-Cycle Approach)

Prepared by Bruce Moeller, CPA, J.D.

Author Biography

Bruce Moeller has been practicing public accounting for about 25 years. A California CPA, he also has a law degree. He also has been a licensed California real estate license and has experience as a registered investment advisor. His primary focus is helping clients' position themselves for success. He does this through getting to know his clients' goals, and then helps them utilize the tax laws for their benefit. One size doesn't fit all.

Born and raised in Marin County, he experienced from an early age just how real estate can build wealth. His parents began buying property in the late 60's & early 70's and he became intimately involved in the real estate operations, decisions, and tax reporting issues. He has seen more people accumulate wealth by employing the "buy and hold" strategy than through other investment strategies. He guides his clients with their real estate decisions to help them maximize their long-term investment and wealth-building opportunities.

Bruce Moeller can be reached at: 394 Bel Marin Keys Blvd., Suite 1, Novato, CA 94949. (415) 884-4444. Email: TheTaxCPA@gmail.com

Legal Stuff – The information may be extremely useful to you. It contains general information concerning the tax reporting of real estate acquisitions, operations, and disposition. Everyone's situation is different. This information is not intended to be direct tax or legal advice rendered directly to you. Use at your own risk. I recommend that you work with a competent tax professional to ensure that your individual situation is clearly understood. For further information, please check with IRS publications, rulings, regulations, cases, interpretations and/or a competent tax or legal advisor.

The purpose of this material is to demystify the tax reporting that goes along with owning, operating and selling real estate. Also, I want to alert you to the opportunities and tax traps that are often presented to you through the real estate life cycle.

The Life Cycle

You have a life cycle, and so does real estate. By understanding how they fit together, you will be better prepared to maximize your financial opportunities that can enhance your life whether it is in real estate or through other investment choices.

Our Income Tax System

Before getting started talking about real estate, it is important to give you a little practical background information about our tax system.

Congress is responsible for developing our complex tax code while the IRS is responsible for interpreting and enforcing those laws. Lawmakers use language that is general enough to apply to many situations. The IRS is authorized to make reasonable interpretations and to make rulings. Many of these rulings are published and can be found at www.irs.gov. People often disagree with the IRS, and some of those disagreements are reported as judicial decisions. Each state has also established a tax code in order to generate revenues from which to operate. If you own property in that state, you become subject to that states' tax reporting scheme. Some states do not impose a state income tax. Most states require that you file a tax return if your gross income from the state (including rental income) exceeds a certain amount. You or your tax professional need to determine which state(s) you need to file tax returns.

Reasonable Minds Can Differ

Often, your intent, the fact and circumstances, trade and industry practice determine the tax treatment. Within the entire practice of tax reporting, reasonable minds can and do differ. There are some clients and tax professionals that like to take a very conservative position and like to sleep at night. They also probably pay more tax. Others are risk-takers and will take an aggressive tax position without much concern for the downside risks, including criminal penalties. Most people fall between the two extremes. I believe that you need to assess your personal comfort zone and to find a tax professional that you feel comfortable working with. That person should know the laws, its interpretations, and where it falls in the spectrum of conservative v. aggressive. That tax professional should be an effective communicator and should explain the risks and opportunities of taking different positions in tax matters.

Still, real estate can be one of the best "tax favored" investments around! Congress has blessed home ownership/real estate unlike no other investment around.

Where else can you buy an investment on a leveraged basis, deduct the costs of carrying that investment, swap one investment for another, and sell it for a $500,000 and (legally) pay little or no income tax? Real estate offers opportunities unlike any other!

The Uses of Real Estate

Real estate falls into several categories. It can be for personal use, rented out to others (residential or commercial), for investment/development, for family members, for vacation use, or used in various business enterprises. Your use for property can also change from time to time depending on your intent. "Intent" is an important tax concept, and you will see it discussed several times throughout this work. The focus of this material is for the investor with residential rental real estate. If you are a "dealer" or developer of property, different rules apply and are beyond the scope of this piece.

Going into the Real Estate Business

If you've gone to a real estate seminar, read books or other publication, you may have a good understanding of how real estate can increase your opportunity to achieve wealth. It is not necessarily an easy route, and you do need to consider the downside risks, too. You need to evaluate whether you have the personal mettle and financial resources to weather the potential challenges that you may be faced with. Making the decision to invest in residential rental property is the first step.

Before you embark on any investment, I suggest that you do your due diligence. Buy good quality properties in an area in which there is strong economic activity. Perhaps you will personally inspect many properties before buying, or maybe you'll buy a property based on images on your computer screen.

As with any business opportunity, you need to keep track of your investment. I suggest that you open a separate bank account to keep the real estate separate from your personal expenditures. Many banks give free checking, especially when you've borrowed money from them. Another help is to use an accounting program such as Quicken or Microsoft Money (or other programs) to keep track of your records. When it comes time to gather your tax information, a separate bank account helps too. Be sure to pay property-related expenses from this account. Remember, you're trying to make money in this business. To the extent you do, Uncle Sam will share in your success. Make sure Uncle Sam shares in those expenses that you've incurred to generate income!

In order to purchase real estate, you need to obtain financing (unless you pay cash), select the property, and enter into a legal contract to buy the property and perform. If you're going to be a landlord, you need to get a tenant, perhaps a property manager. You'll also need insurance to protect your investment. There are many decisions to be made when you're ready to purchase a property. Consult qualified professionals!!!

Buying Property – Taking Title

The title company, lawyer, real estate agent, loan agent, and others will be available to help you. You will also be asked how you wish to take title to the property. While title can generally be changed at any time, deal with this issue before there are conflicts and problems. I strongly recommend that you talk with your attorney or tax professional

about this before you close. There are income tax, estate, beneficiary, tax, creditor issues, reimbursement issues, divorce and a myriad of other potential problems that can arise. Any time you own property with someone else, you take on potential risks that the other person brings with them. . . while they're alive, and after they die. (Corporations, trusts, partnerships, and Limited Liability Companies may be appropriate for you, but they are beyond this scope of this article).

Typically, as individuals, you have the following choices:

Sole Ownership – You own it by yourself. If you're married, you can still be the sole owner but you'll need to get the consent of your spouse to take title.

Joint Tenancy – This is often used, but has some surprising features. Each owner is an equal owner of the property. (two each own 50%, three each own 1/3, four each own 25%, etc.) If two people own a property as joint tenants, when one person dies, the survivor becomes the sole owner. This is true despite a will saying otherwise. If four people own property as joint tenants and one dies, then the surviving three own the property.

Tenancy in Common – This allows people to own different %'s of the property. There is no survivorship feature so a person who owns property in this fashion can give it to someone through his or her will.

Community Property – If you are married and live in a community property state (such as CA), then you can take title as community property. This permits the full step-up to fair market value when one spouse dies. For example, if a married couple owns a property as community property that cost them $100,000 but is worth $1,000,000, when one spouse dies, the new "tax basis" is adjusted to $1,000,000. The surviving spouse could then sell the property for $1,000,000 and pay no income tax. However, if they owned the property as Joint Tenants, only one-half of the property would be stepped up. This means that the survivors share would have a tax basis of $50,000, plus the decedent's share.

Community Property with Right of Survivorship- California established this method of taking title for married people. It appears to have some of the best features around. Please check with your attorney if you're married. It may or may not be appropriate for you.

Revocable Trust – If you have done estate planning and have created a trust, your attorney will probably advise you to have your property titled in the name of the trust. There are a number of compelling reasons to have an estate plan prepared for you by a competent attorney. A trust is a document that empowers someone you appoint to make decisions for you when you cannot. It allows that person (the trustee) to make decisions instead of the courts. It generally gives you more control, flexibility, privacy, and is less costly.

You've bought property! What next?

Residential Rental Real Estate – Closing Statements

Generally, when you purchase a piece of property, you receive a closing statement from a title company. There is a laundry list of items and amounts reflected in debit or credit columns. You (or your tax preparer) will need to report these and perhaps other items with your tax return. You need to keep these records permanently, or until you've sold the property and the statute of limitations has expired. Any time you buy, sell, or refinance a property you should get a closing statement. It has tax ramifications. Give it to your tax professional.

Generally, your starting point for reporting is the purchase price. To that, you need to add certain closing costs. They are:

Typical Settlement charges:
Loan origination fees (points)
Appraisal fees
Credit reports
Inspection fees
Tax service fees
Flood check fees
Processing fees
Title insurance
Legal fees
Notary fees
Lender's coverage
Title fees-search
Document preparation
Misc. fees.
Property inspection costs
The costs you incurred in finding and buying this property
Allowances from seller or title company
(This list is not all-inclusive)

There are some costs that will show up directly on your tax return from the closing statement. For example, property tax pro-rations, property hazard insurance. There may be other items on a closing statement that need to be analyzed by your tax professional. Some costs should become part of the property, while other costs are part of the loan.

Land v. Building & Other Allocations and Depreciation

Once you have determined your "tax" cost, you need to make an allocation for the building and the land. The building can be depreciated over 27.5 years while land cannot be depreciated. How do you make the allocation? Well, there is an element of judgment to this including a review of the facts and circumstances. One indicator is the property tax assessor's allocation. Another factor is the value of similarly improved land, providing it is comparable to your land. There are many factors, and this is why you need to enlist the

services of a competent tax professional to assist you in making this decision. Once made, the decision is binding unless you obtain the consent of the IRS Commissioner. (Note: If you purchase appliances or personal property that can be easily removed (refrigerator, stove, washer/dryer), you can depreciate them over a shorter period.)

I strongly recommend reporting both the land and building on your depreciation schedules while some practitioners do not. I like to keep track of it because at some point, you may wish to sell or exchange the property and you then need to know the cost of the land in order to report the transaction. Keeping this information with your return saves time and digging through old records.

Depreciation

We know that buildings generally deteriorate over time. The tax rules allow you to recognize the deterioration through a tax deduction called "depreciation." Even though the property is increasing in value, you still get to claim this deduction! Under the tax code, residential rental property generally can be depreciated over 27.5 years. So, a building with a tax basis of $137,500 will generate a depreciation deduction of $5,000 per year. (Unfortunately, there are some complex rules that may apply in the year of acquisition; something called "AMT," and limitations that may apply when you generate a loss from the rental. You will need to work with a competent tax preparer if you fall within some of these complex rules).

Assets used in connection with a rental property can be depreciated over its "useful life." That life can vary depending on the type of asset.

Amortization

Some expenses result in the creation of an intangible asset. For example, if you refinance your rental property, those costs may be captured and "written off or amortized" over the life of the new loan. If you refinance again, those unexpired costs can be written off while the new costs will again be captured and amortized.

Other Deductions

Generally, you can deduct expenses related to your business. The Internal Revenue Code (IRC) says you can deduct "the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business." IRC Section 162. This means that just about anything that you need to spend to make money can be deducted, with a few exceptions.

Principal payments on your loan are not deductible. Improvements (not repairs) are not deductible. (A repair is defined as the incidental costs that neither materially add to the value of the property nor appreciably prolong its life.) Some people expense a stove or dryer while others depreciate them over five or seven years. Check with your tax professional for their opinion.

Tax Reporting – Schedule E

Your property activity ultimately will be reported on Schedule E. Enclosed is my form (attached at bottom.) This is where you report the income/deductions to the tax authorities on an annual basis. To save your preparer time and avoid confusion, please set up your information (whether in quicken or some other system) in accordance with these categories.

Phase II - Operations

After you've owned the property for a while, you become familiar with the joys and frustrations of being a landlord. Hopefully, you've had good tenants who take good care of your property and it has increased in value. Over the long haul, more people have become wealthy with real estate than any other investment.

Deducting Losses on Real Estate

There are a number of rules governing the ability to deduct losses on real estate. It is a confusing area and may limit the ability of people to write-off current expenses. Many CPA's do not understand these rules and many IRS agents do not understand them either. Please feel free to peruse the IRS publication 925 concerning rental real estate and passive activity losses. Keep in mind that these rules apply on a year-by-year basis. You may be a "Real Estate Professional" in one year, but not the next. Your "Status" can change from year to year and it will affect the tax treatment of your real estate activities.

Background: Congress perceived that people have taken too much advantage of certain so-called "loopholes." For example, a successful businessperson earns $300,000 in wages, then enters into a highly leveraged equipment leasing program and "loses" $250,000 due to depreciation deductions on the equipment. In this situation, the businessperson only took bare paper title to the property and wrote a check. In 1986, Congress changed all of the rules. No longer can the businessperson legitimately offset his wages with this "new business" opportunity. Because of these abuses, the rules governing residential real estate were also changed.

Active, Passive, or Real Estate Professional?

The current tax structure allows current tax deductions in certain circumstances depending on the extent of personal effort of the taxpayer in connection with their real estate operations. Keep in mind that even if you are unable to obtain the maximum tax benefits on a current basis, real estate continues to be an incredible investment opportunity. Further, real estate investors are generally interested in buying properties that generate cash flow. With a positive cash flow, generally, the only deductions that would be limited would be depreciation. The limitations imposed by the 1986 Tax Act do not offset the real wealth creating opportunities of real estate. It does, however, limit the attractiveness of highly leveraged investment programs where people do not materially participate.

If work full-time as a wage earner and earn more than $125,000 per year, you may derive only a portion of the current tax benefits of real estate. What happens to the losses that you cannot claim? Generally, they are suspended until the property is sold. If you have suspended losses from one year, generally you cannot claim them in the following year because you then qualify as a "Real Estate Professional."

If you work full-time and earn less than $100,000 per year and "actively participate" in the real estate operations, you can deduct up to $25,000 in losses. With most real estate investors, you would probably need to own 4-8 properties to support claiming such losses. Any losses in excess of the $25,000 would be suspended and allocated to the rental properties.

If you are a "Real Estate Professional," the losses incurred from owning and managing your property is not subject to any limitation. For some people, they will want to become a Real Estate Professional. However, it is not necessarily easy to become one. Congress has imposed the following requirements to qualify as a Real Estate Professional. You must spend more than 50% of your work-time and more than 750 hours per year to real estate development, construction, acquisition, conversion, rental, operation, management, leasing, or brokerage. This amounts to 62.5 hours per month, or about 14 hours per week. There are many part-time real estate agents that, I suspect, don't spend that much time involved in these activities, yet are never challenged. I have developed a number of strategies that I believe will withstand IRS scrutiny if they challenge a taxpayer's status as a real estate professional. My approach does, however, require focusing on the client's activities and reporting methods. If you report your real estate activities (and significant current deductions) as a "Real Estate Professional" and the IRS challenges it, you will need to redo your tax returns, tax carryovers, and pay additional tax and penalties. California has not conformed to the Real Estate Professional rules, and regards all residential rentals as passive.

Election to aggregate real estate activities: If you provide the requisite number of hours of service to qualify as a Real Estate Professional by working on a number of projects/properties, you may need file an election with your tax return. Each property is generally considered one activity. By electing to aggregate the properties, you may qualify all of the properties. There are some traps, however, because it affects the future allocation and reporting of gains and losses on disposition. Please discuss this with your tax professional for more information.

The 1986 Tax Act came up with some new terminology that needs to be explained to you. It continues to be refined by IRS publications and decisions and case law. The following information is general. Facts and circumstances affect the ultimate determination.

A person's relationship to their real estate is "Active" when that person provides direct personal services. If you own a rental, find your own tenant, do background checks, personally prepare the property for rental, paint, clean, etc. It is clearly active. To the

extent you delegate these activities; it becomes less "active." If you hire someone to screen tenants and take on some of these duties, it becomes more "passive." Yes, it's a matter of degree and personal involvement. For that reason, I encourage you to take more control of your properties if you are looking for immediate tax deductions.

Clear "Passive" status is where you delegate all responsibility for managing the property to others. You can only offset passive losses with passive income, so unless you're "active" you'll not get a current deduction on properties with losses. For example, if you're an investor in a real estate limited partnership, you are a passive investor by definition. The income you would generate through a real estate limited partnership would be characterized as passive.

Refinancing

If it has increased in value, you may wish to expand your real estate empire and buy another property. If you refinance the rental property, there are some important tax rules relating to the loans. Generally, the IRS allows you to deduct the interest expense to the extent the loan is related to the borrowing to acquire property. If you refinance a rental and take money out, you need to trace where the money went. Let's say you had a $100,000 loan on the rental and get a new loan for $150,000. You can still deduct the interest on $100,000 against the rental, however, the interest paid in connection with the additional $50,000 loan is deductible if it's used in a profit-making activity. Simply stated, if you use the $50,000 to take a vacation, it's not deductible. If you buy another rental and put $50,000 down, the interest paid on that $50,000 debt is deductible against the new rental. If you use the $50,000 to buy stocks, it's then considered "investment interest" and other rules apply. Confusing? Yes. . . it can be. Talk with your tax professional about the tracing rules related to a refinance of property.

Transaction Decisions

In the life cycle of owning property, things can change. The rental may become a personal residence, a vacation home, a home for your kids while they're going to college, or any number of other uses.

You may decide that you've reaped the bulk of financial benefits of that property and wish to get rid of it. What should you do? First, determine the extent to which you have gain in the property. Remember-depreciation reduces the tax basis of your property. If you sell at a gain, you may have to recapture or "pay back" the amount of depreciation you've deducted. If you have suspended losses, they will reduce the taxable gain when you sell.

So Many Options!!!

The beauty of real estate investing is that you have many choices. Paying taxes is not necessarily a bad thing, but there are a myriad of other options depending on your intentions, plans, and goals. If you have children or others (including charities) to whom

you want to help, you can sell it at a discount or gift it to them. There are other strategies you can use, like Charitable Remainder Trusts, Qualified Personal Residence Trusts, Grantor Retained Income Trusts, and a host of other strategies. The choices that may be available to you are staggering. Also, "how" you do it is important, so check with your tax professional first. In general, however, when you obtain a tax benefit, you do have to give up some control over the property. If you retain control, you generally limit the tax benefits.

Estate Planning

When it comes to estate planning, there are a number of important strategies to consider. Assuming that real estate has created wealth for you, your estate may be subject to estate tax. Generally, the estate tax is due within nine months of the date of death and is based on the value of your estate, net of deductions, at the date of death or the alternate valuation date. Estate planning is a hugely important item to consider and is generally beyond the scope of this material. However, I strongly advise you to work with a competent lawyer who can advise you through the years.

The estate tax is based on the value at the date of death. You can take some steps to effectively reduce the "value" by gifting fractional interests in your properties to your beneficiaries in advance of your passing. By doing this appropriately, you can effectively give more property away and pay less in federal (and state) estate tax. This is entirely legal and appropriate, but is not to be entered into without adequate planning. Again, estate planning must be done with a competent attorney who has experience with real estate, trusts, and who knows your plans and goals. It often takes time to develop an appropriate strategy for you, and your plans may change over time. Over your life cycle and that of your beneficiaries, you may need to revise your plans from time to time.

Exchanges under IRC Section 1031

If you want to continue owning property, you can enter into an exchange agreement and transfer your low basis property to another property (or properties) providing you adhere to the strict requirements to qualify as an exchange. Essentially, the property must be "like-kind" which means that you can exchange rental property for rental property. Residential rental property can be exchanged for a commercial rental. "Like-Kind" doesn't mean identical. You are also required to acquire a replacement property costing as much or more as the property you give up. You can also not receive cash in the process.

Some people refer to this section as a "Tax Free" exchange, but that is not correct. An exchange under IRC section 1031 lets you swap property and keep your lower tax basis. It permits you to "defer" taxes on the swap.

Exclusion of gain from sale or exchange or principal residence – IRC 121

Some people may remember the old tax rule where you could avoid paying tax on the sale of your home so long as you bought another one that cost as much or more. Those rules are gone, and have been replaced by an even better provision!

Now, in many instances, you can avoid paying taxes entirely! It is an amazingly wonderful tax opportunity! Code Section 121 allows you to exclude taxable gain of $250,000 for a single person, or $500,000 for a married couple on one property no more than every two years. *There is no limit on how many times you can do this* under current law. My advice to clients is to find a way to use this provision when you contemplate selling and cashing out of property. If you want to completely divest yourself of the property, you may wish to move into it and live there for two years. If you qualify, you may be able to pay no tax due to the liberal provisions of IRC Section 121, other than some depreciation recapture. Further, you can employ this method every two years. Seems like a nice way to cash out "tax free" in your retirement years.

Maybe you have a rental property in Kansas but you'd like to retire in Florida. What could you do? Consider doing an exchange from Kansas to Florida. Keep the Florida property as a rental and later, you can convert the residence into your principal residence. Recent federal legislation (2004) requires a five-year to convert the property to a principal residence if it was the subject of an exchange. This is a powerful tax avoidance tool.

In late 2005, the IRS issued a revenue procedure that, under the right circumstances, allows a person to avail themselves of the Section 121 exclusion ($250K or $500K) AND IRC Section 1031 (tax deferred exchanges.) Effective 1/1/2009, however, these rules have been modified for "non-qualified use" to allocate the potential exclusion based upon the time it has been a principal residence. These rules are new. Contact your tax advisor for further updates.

Installment sales

Still, if you decide that you wish to sell, you can effectively transfer the real estate into an annuity by using an installment sale. This lets you report only a portion of the gain as you receive payments from the buyer. You defer the tax on the gain, and you can collect a market rate of interest on the balance. Here's how it works.

Say you have a property with a tax basis of $100,000 and a value of $200,000 and a loan against the property of $50,000 so you have equity of $150,000. You agree to sell the property to for $200,000 but need to pay off the $50,000 loan because there is a due on sale clause.

Under an all cash sale, you would recognize gain of $100,000 and end up paying anywhere from $26-28,000 in federal and state tax leaving you with approximately

$122,000- 124,000 after tax. Under today's interest rate structure you would earn approximately $1,800-2,000 in interest income. . . .Guaranteed!

Under an installment sale, you become the bank and finance the purchase price to the new buyer. You need to payoff the bank, and you need some cash to pay the current tax associated with the sale, so you effectively loan the buyer, say $130,000. The tax calculation works out like this:

Sales price	$200,000
Tax Basis	$100,000
Gain Realized	$100,000

Gain recognized:

Cash Received (cash of $20K, pay off $50K)	$ 70,000
Gross Profit % ($100,000/200,000)	50.00%
Gain Recognized ($70,000x50%) =	$35,000
Tax on gain (26-28%)	$9,500-10,000

So, after the sale, you pay the tax of about $10,000, and keep $10,000 for yourself.

Now, you're "the bank" collecting both principal and interest payments from the buyer. Say you're collecting 6.5% amortized over 30 years. You will be receiving a monthly payment of $821.69. The interest is fully taxable, while the principal payments received are 50% return of capital, 50% capital gain. You can generally structure the loan directly with your seller to achieve your financial objectives.

Summary – Conclusions

In a work of this nature, it has to be limited in scope. Questions will undoubtedly arise and you will need to get professional advice.

Few investments offer the opportunities that real estate does. Depending on your personal circumstances and goals, this may offer the best way to create wealth for you and your loved ones.

Investing, whether in real estate or other opportunities, is not a short-term, instant gratification process, but one that takes time. Over time, you can realize the benefits of saving now for your financial future. Along the way perhaps you will instill in others the qualities it takes to be successful as an entrepreneur and pass your knowledge and experience to others.

We are privileged to live in a country that offers so many, such great opportunities. I give my thanks to the many people who have helped me along the way, and offer my best wishes to you.

As always, we welcome your input, comments and suggestions.

RENTAL INCOME/EXPENSES
Substitute Schedule E

	Property A	Property B	Property C	Totals
3. Rental Income				
5. Advertising				
6. Auto and travel				
7. Cleaning and maintenance				
8. Commissions				
9. Insurance				
10. Legal and other professional fees				
11. Management fees				
12. Mortgage interest paid to banks				
13. Other interest				
14. Repairs				
15. Supplies				
16. Taxes				
17. Utilities				
18. Other (list)				

Examples of other expenses:
Rent collection fees
Association dues
Gardening
Painting and decorating
Pest control
Plumbing and electrical
Supplies
Telephone
Wages and salaries
Outside services
Depreciation
Amortization

Property inspections
Minor tools
Replacements
Meals
Software
Property and equipment rent
Property research
Credit Checks
Appliance maintenance
Tenant gifts
Postage and delivery
Laundry income (   )
Office

Note: Categories with numbers refer to the actual IRS tax forms number. Use these categories to assist your CPA or tax preparer. The other expense categories are samples of other often-used categories.