Chapter 1

CHOOSE THE TAX LAWS YOU WANT

If you had a choice of paying tax now or later, which one would you choose? How about if the government asked you whether you would like to pay tax equal to half of your income, or tax at a rate of 10 percent or less? The amazing thing is though, that this *is* exactly what the government asks us, each and every day. And we choose what tax we will pay, by the actions that we take.

If you choose to continue working at a job or in a profession where all of your income is earned by the work that you do, you will pay the highest rate. If you choose to work a little harder by taking another job or working overtime hours, your tax goes up along with the income you make. But, if instead you choose to invest in real estate and do that investing in conjunction with a tax plan, you will pay less tax.

First, though, let's look at how the tax system actually works.

WHY CAN'T I EVER GET A STRAIGHT ANSWER ON A TAX QUESTION?

Have you ever wondered why you can't get a straight answer to your tax question? Or worse, have you asked numerous people and gotten numerous answers? Why does this happen? The answer is quite simple. As we said earlier, tax law is complex.

Did you know that there are more than 500,000 pages of written tax law? (That makes it roughly 5,000 times as long as the Constitution!) And, what's more, tax law is constantly changing and being modified. Every day is a new day when it comes to taxes! Consider that there were more than 400 IRS Code changes for 2001. And for every code change, there are also one to five accompanying Treasury Regulations, Revenue Rulings, Revenue Procedures, and eventually multiple tax court cases. So more than 400 Code changes—and 2001 was considered a pretty uneventful year in the tax world! Now contrast that with years like 2002 when a new tax act came into play. In a busy year, you can have several thousand changes to the tax laws.

Now let's add another layer of complexity. There are three different key players in determining tax law: Congress, the IRS, and multiple district tax courts. Sometimes these different players don't agree. There are numerous instances of conflicting tax court opinions. And sometimes the code isn't even consistent within itself.

To make it even more complicated, tax law is comprised of "facts" and "opinions." A fact is something that can be proven to exist through physical evidence, while an opinion is something that may or may not be true. A tax fact is something that is so simple and clear-cut that there is only one answer. An example would be the instructions that tell us what line of our tax return form our income should go on. A tax opinion is much less clear.

It is based on an interpretation of facts, and it may or may not be true. An example of a tax opinion would be how much income needs to go on that line of our tax return form.

Most tax decisions are made based on opinion, which may or may not be true. Fortunately, there is a lot of guidance in tax law that helps informed and educated tax strategists make good decisions. The problem occurs when partially informed people try to make tax decisions. Tracking all of the tax law changes is a full-time job, and it is not something that a casual advisor can do well.

Believe it or not though, the worst answers of all can come directly from the IRS. Its agents are given only three days training before they are let loose on the Service Center telephones as "experts." IRS agents frequently don't even have accounting degrees. And if you get bad advice, the IRS is not liable for giving you that bad advice. In the late 1990s, the IRS did a much-publicized internal study of its own ability to answer questions. It discovered, to its chagrin, that the telephone questions were answered wrong almost 33 percent of the time. A recent internal study was done, a little more quietly this time, and it was discovered that questions are now answered wrong more than 40 percent of the time! And if you get the wrong answer, follow that advice, and are then later audited—you will pay tax, interest, and penalties.

To make matters worse, there are few CPAs who really understand real estate investment tax issues. The American Institute of Certified Public Accountants (AICPA) recently estimated that more than 80 percent of CPAs do not understand the basics of real estate tax issues.

So the bottom line is that we have a complicated set of tax laws, influenced by individual circumstances and understood by few. *The Insider's Guide to Real Estate Investing Loopholes* can help de-mystify tax law.

DO I REALLY NEED TO KNOW ALL THIS?

Well, yes and no. A major frustration for taxpayers is asking a question and being told that the answer is, "It depends." Accountants are famous for answering "it depends" to just about any question, but the fact is, the right plan really does depend on your own circumstances.

This is where you need to rely on your tax experts to further interpret the entire body of tax law based on what you want and need. It's not your job to be the tax expert (unless, of course, that really is your job). It is, however, your role to understand what they are talking about. Accountants, just like most other professionals, really do have their own language sometimes. If you want the best results, learn to speak their language.

QUICK-START GUIDE TO TAXES

So how do you become an expert on more than 500,000 pages of constantly changing tax law? Good news! There is actually a simple formula that explains how tax in the United States is calculated. It is called the Three Stage Tax Formula.

To do a Three Stage Tax Formula calculation, you:

- Report gross *income*.
- From gross income, you subtract *deductible expenses* to come to the amount of taxable income.
- Multiply the taxable income by the *tax rate* to determine the amount of tax.

It actually sounds quite simple, and a good tax strategy will encompass each of these stages. The key is to learn how you can manipulate each of these stages to your advantage, using IRS-approved loopholes.

- **Income:** What is income? What are the different types of income? How can you change from one type of income to another and why does it matter? How can you turn taxable income into tax-deferred income or tax-free income?
- **Expense:** What expenses are deductible? How can you make use of multiple business structures to create expenses on one side that are not income on the other? What personal expenses do you have now that are really hidden business deductions?
- **Rate:** One of the best provisions that we have in the United States, and that many other countries do not have, is the ability to make use of a graduated tax rate. This means that there is not a flat tax rate applied to your taxable income. Instead, a portion of your income is taxed at one rate and then the next layer of income is taxed at a higher rate, and so on. If, for example, you have a tax rate of 28 percent for your personal return, this actually means that you have already filled up the income portions allowed at 10 percent and 15 percent, and for every additional dollar you make over these two amounts, you will pay 28 percent. So you aren't paying 28 percent on all of your income, only the amount that exceeds the 10 percent and 15 percent portions. We call 28 percent your marginal tax rate. Now how can you move income from your higher tax rate to a lower (or zero) tax rate?

A financial and tax strategy that incorporates real estate is the easiest way to impact ALL levels of the three stages—income, expenses, and tax rate. Real estate also allows an employee to deduct

Three Questions to Ask Yourself
(If You Really Want to Reduce Taxes)

Income:	How can I change the type of income (earned, portfolio, or passive) I currently have to reduce taxes?
Expenses:	What personal expenses do I have that might be hidden business deductions?
Tax Rate:	How can I move my income to a lower tax rate?

many business expenses that normally would not be deducted against their wages. Finally, real estate, more than any other type of investment, has the widest range of tax law available to reduce, and even eliminate tax.

THREE BASKETS OF INCOME

Since the 1986 Tax Reform Act, the IRS has defined three different "baskets" of income. They are:

- Earned income—you work for the money.
- Passive income—your business or real estate works for you.
- Portfolio income—your money works for you.

Earned income is taxed at the ordinary tax rate. If you are self-employed but have the wrong business structure in place, you will also pay self-employment tax of 15.3 percent. If you were paid at the highest tax rate in 2004, that would mean a tax rate of more than 40 percent, for federal tax alone!

Portfolio income is usually in the form of long-term capital gains (assets sold after owning for more than one year) or dividends, and has a maximum rate of 15 percent.

Passive income such as that earned from real estate, if set up correctly, can receive cash flow with no tax whatsoever.

So based just on tax rates, it makes sense to move from earned income to portfolio or passive income. Real estate investing can help you do that!

There is one important thing to note about the three baskets of income, and that is there are many restrictions on losses and expenses that are incurred within these three categories. For example, you are limited in the amount of passive loss that you can take against earned income. You are similarly limited in the amount of portfolio loss (such as investment expenses or loss on sale of stock) that you can take against earned income.

REAL ESTATE LOSSES

Since 1986, U.S. tax laws have stated that losses can be claimed only against income in the same category. For example, passive losses can be used only against other passive income. You cannot take passive losses against earned income. Investment expenses, such as expenses for margin interest or investment education, can go only against portfolio income.

In the case of real estate the rules regarding passive losses are more complicated. If your income is less than $100,000, you are allowed to deduct up to $25,000 in losses from your real estate against other income. If you have more than $25,000 in losses, the excess amount is held as an unallowed loss until a future date when you sell the property. You don't forfeit the loss, but it's not very good tax planning to put off that loss to the future.

If your income is $100,000 or more, the amount of loss you can currently deduct is phased out. The unallowed loss is "suspended" against a future date when you sell the property. So the loss isn't "lost," but it is deferred. That's not great planning, either!

But, here's our first loophole, which will help you with this: Qualify as a real estate professional. If you are a real estate professional, you can take an unlimited amount of real estate losses against your other income.

TAXABLE INCOME

The three baskets of income are considered "taxable income." The IRS defines taxable income as "gross income" and says that "Except as otherwise provided . . . gross income means all income from whatever source derived." The best tax planning is in finding the loopholes that are defined within "except as otherwise provided."

For example, here's another great loophole available through real estate: Take money out of a property by refinancing. The cash you receive would not be taxable. Of course if you refinance, the payments on the property would go up. However, if you have been a responsible landlord, you will have been increasing the rents to offset the increased payments that would become due under a refinance.

On the other hand, what if you hadn't increased rents and couldn't get any additional rent from the property?

Say you refinanced a property and took out $100,000, intending to use that money for another investment. Your refinanced property now has additional mortgage costs of $7,500 per year. You used the $100,000 from the refinance to buy another building for $500,000. This building created a 15 percent cash-on-cash return in an area that had a conservative appreciation rate of 6 percent. After five years, using the refinancing loophole, here's what could happen:

Cash flow in new building = $7,500 ($15,000 minus mortgage payment of $7,500).

Cash flow total for five years: **$37,500**.

Appreciation = **$169,000** (after five years).

Total Increase: $206,500.

Wow! Debt can make you rich!

TAX-ADVANTAGED INCOME

The IRS has provided ways to take what would otherwise be taxable income and turn it into tax-deferred or tax-free income.

Tax-deferred income means that you put off having to pay tax until a later date. The benefit is that your money grows at a faster pace. For example, assume you pay tax at a 28 percent marginal tax rate and you earn $1,000 per year. After taking out money for taxes, you actually have only $720 available for future investment. On the other hand, if all of the amount can continue to grow, there is more available to grow. For example, if you invest that $1,000 per year at 12 percent for

20 years, the difference between paying tax each year and being able to defer that tax to a future date would mean an additional $6,456 in wealth. If you invested the $1,000 for 10 years, the difference is only $1,179. The unknown factors, of course, include the amount of interest you will earn and the future tax rate.

Tax-free income, on the other hand, means that not only does the investment grow without tax, but you can also liquidate that investment and take the value without paying tax on it. Obviously, tax-free income is the best way, wherever possible.

DEFERRED TAX

There are three ways to hold or transact real estate in a way that tax can be deferred. Sometimes you can even defer that tax forever!

1. *Installment Sale:* If you sell a property over time, that is called an installment sale. In other words, you will receive installments of payments over time. Each payment you receive is composed of at least two parts: (1) principal and (2) interest. The interest received will always be taxable just like any other portfolio income. However, in the case of the principal, it will actually be only partially taxable, depending on how it is apportioned between gain and return of capital.

   The calculation is important for two reasons. First, you are required to report the mortgage interest that you receive on a Form 1098 on an annual basis to the person paying you. Second, you will need that calculation to complete your year-end tax return. In both cases, I strongly recommend that you use a qualified accountant to prepare and calculate the forms, or at least use them to check your math!

A word of warning regarding installment sales. If the IRS considers you a real estate dealer (involved in the trade or business of real estate trading), you cannot qualify for installment sale treatment on payments. If you are a dealer, you must take all of the gain as taxable immediately. That means you could be in the position of paying tax on income you have not yet received! More on this in Chapter 2 "Tax Traps to Avoid."

2. *Buy real estate through your pension plan.* Some pension plans allow the purchase of real estate through your pension plan. There are some rules to follow about how you do it and some restrictions as to how the mortgages are handled, but there are a lot of benefits to doing your investing this way. For example, with a regular pension plan, the gain is deferred until you withdraw it from your pension plan. With a ROTH plan, you never pay tax. For more on this, see Chapter 2 "Tax Traps to Avoid."

3. *Section 1031—Like-Kind Exchange.* Currently, under U.S. tax law you can exchange real estate with someone else, in certain circumstances, and defer the gain that you would otherwise have to declare. The most common way to do this is through a "like kind," "Starker," or Section 1031 Exchange. These are all different ways of saying the same thing.

The like-kind exchange is described in IRC Section 1031 and further defined in a court ruling, *Starker* v. *Commissioner*; hence the other names. To keep things simple, we refer to the exchange as a "like-kind exchange." This is a specific exchange of real estate that has been owned for business or investment purposes. You cannot do a like-kind exchange (under this Code Section) on your personal residence or on non-real estate items. The like-kind exchange allows you to sell a piece of property that has appreciated, and "roll over" the gain into another piece of property. The second piece of property merely has to be another piece of business or investment real estate. It does not need to be the same type of investment property. You can exchange many properties into one property or vice versa. For example, you could exchange a single-family residence into an apartment building or a single-family residence into many single-family residences or bare land into two single-family residences. The possibilities are almost endless.

There are some rules for a like-kind exchange that must be closely followed. (See Chapter 7 "Sell Your Property without Immediately Paying Tax" for more details.) If you are considering a like-kind exchange, make sure you notify the real estate agent who is selling your property, as well as the title company. They will put you in touch with an exchange agent who will facilitate the sale and ensure the complex rules are followed.

Three Types of Income

Taxable—Tax Now

Tax Deferred—Tax Later

Tax Free—Tax Never

What type of income do you want?

WHY TYPE OF INCOME MATTERS

Once you understand what income is taxable and what type of income you have, you might find that you want to change the character of the income you receive.

Earned income means just that—you have to earn it. If your goal is financial freedom, which means the money you don't work for (your passive and portfolio income) exceeds your monthly expenses, then you want to turn earned income into the other forms. You can do that with your business, particularly if it is in the form of a C corporation. These strategies are covered in *Loopholes of the Rich—How the Rich Legally Make More Money and Pay Less Tax*. If you currently have a business producing income, you may want to discover the ways to change the type of income from your business (earned) into passive income through the use of real estate.

TAX RATE MAGIC

In real estate, there are even more opportunities to take advantage of lower tax rates due to special loopholes written for real estate investors and special capital gains treatment. Some of these advantages follow.

Tax-Free

We said earlier that tax-deferred income means that you will pay tax at a future date, whereas tax-free income means you will never pay tax. Obviously, tax-free income (as opposed to tax-deferred) is the way to go!

Much as with tax-deferred income; there are many different ways that you can have tax-free income. The first way is through a type of business or investment structure such as a ROTH IRA. The second way to produce tax-free income is through specific provisions within the current tax law as they pertain to real estate. The best example of that currently is with the tax-free gain that is allowed through the sale of your principal residence. You can now deduct $250,000 (if you are single) of gain on the sale of your home you have lived in for two of the past five years. If you are married, the exclusion amount jumps to $500,000. Chapter 10 "Be Paid to Live in Your Home" explains in more detail about how you can make use of this tax gift from Congress. Don't miss out on this exclusion!

Another way, often forgotten, is simply through refinancing. Think about it. If you own stock, about the only way to access an increase in value is to sell the stock. You've now got your cash, but have lost the appreciating (you hope) asset. But if you have real estate that has gone up in value and is likely to go up again, you can access the money through debt! We saw an example earlier in the chapter of how debt can make you rich. And you were able to get to that money to start that second investment without paying tax.

CAPITAL GAINS TAX

The tax rate for capital gains is less than the ordinary income tax rate. Unfortunately, tax law rarely is straightforward. The capital gains rate kicks in only when an asset is sold after a holding period of more than one year. Additionally, the gain is calculated using four key terms: sales price, basis, cost of selling, and accumulated depreciation. It's not simply a result of how much cash you end up with. We discuss this in greater detail in Chapter 16 "Accounting for the Sale."

OTHER TYPES OF TAX

The preceding review of tax planning discussed only the income tax implications. Unfortunately, it isn't all that simple. There are even more taxes to consider. Major ones follow:

1. *FICA.* This tax, known as self-employment tax when it isn't specifically a payroll tax, is 15.3 percent on all net business income, up to the current limit on Social Security ($87,900 in 2004) and 2.9 percent after that. This tax is only applicable for trade or business income earned either in your own name or in a business structure that doesn't protect against the tax.
2. *Alternative minimum tax.* Even the best tax planning won't necessarily protect you against the alternative minimum tax. This tax was developed years ago to ensure that the wealthiest Americans didn't completely escape paying tax. Unfortunately, many Americans making more than $50,000 are now becoming subject to this alternative method for calculating tax. Certain "tax preference" items are not allowed for alternative minimum tax calculations, and most of these items specifically target real estate professionals. To determine whether or not you are subject to paying alternative minimum tax, you must first complete a complicated form to determine the amount of alternative minimum tax due, complete your regular tax return to see how much you would pay in regular taxes, and then pay the higher of the two. Chapter 8 "Avoiding the Ticking Tax Bomb" gives some tax loopholes for the alternative minimum tax.
3. *Property tax.* The National Taxpayers Union (NTU) recently stated that it estimates 40 percent of all property owners are paying too much in property tax. Property tax is a multiple of the property tax rate times the estimated market value of

your home. In some cases the market value is additionally reduced by an assessment ratio. Whatever the assessment ratio in your area might be, the estimated market value of your house might very well be too high. Yet fewer than 5 percent of homeowners ever challenge their assessments. Governments have no incentive to change their current method of assessing. By the way, according to NTU, more than half of those who appeal their current assessments win.

4. *Transfer tax.* Real estate transactions often require payment of a transfer tax. The amount will vary based on the location of the property. For example, in Washoe County, Nevada (Reno, NV), a transfer tax equal to 0.41 percent of the gross sales price is applicable. This high cost helps the state recoup some of the tax money it has lost as gaming has grown in other states.
5. *Estate tax.* Real estate ownership is often the biggest asset that someone will have when they pass away. And depending on the value of that asset (along with other assets such as cash, personal property, and life insurance proceeds) and the year in which the person dies, there could be a lot of tax associated with the property.

STATE TAX

Besides the preceding taxes, there is also the issue of state income tax. You will pay state income tax depending on the state in which your property is located.

If you live in Arizona and own property in California, you'll pay California income tax on the California income. If you live in California and form a Nevada business structure to hold your New York property, you'll pay New York tax. There is a calculation made on your own home state tax return that will, in effect, give you some credit for the tax you pay in the other state. It isn't necessarily a dollar for dollar credit, though. The final result will depend on how the involved states calculate their taxes.

There are many opportunities for tax loopholes for real estate investors. Proactive planning helps you determine how much and when you pay your taxes.

ACTION STEPS

Income—How much cash have you generated in the past year from each of these categories?

Taxable—(earned, portfolio, passive)

Tax-deferred—(pension, Sec. 1031)

Tax-free—(ROTH, principal home, loans)

What is your current marginal tax rate?

What have you done to address alternative minimum tax and estate tax issues?

If you are paying too much in tax, what strategies do you currently use to reduce your tax rates?

After review of the preceding, what two action steps do you want to take to change the amount of tax you pay?