LESSON FOURTEEN

Dynamics of Financial Freedom

INCOME TAX SAVINGS

A TAX PHILOSOPHY

It is not enough anymore to know how to make money; you also have to know how to keep it. Real estate investors are one of the most highly-favored groups as far as the opportunity to save on income taxes is concerned. Because the subject of income tax is such a complex one, it is recommended that you read as you listen to this lesson. Stop the tape to examine the various charts and examples. Apply the suggested strategies or examples to one of your own properties to determine how they would affect your tax situation.

Take maximum advantage of real estate's tax-saving opportunities by adopting a clearly-defined tax philosophy to handle the two kinds of tax laws: those areas where the law is clear, and those which are gray areas.

When there is no question about whether you are entitled to use a particular method of deduction, no problem exists; you follow the law. Some areas, however, are less clearly stated. For example, before you can calculate the amount of depreciation to claim as an expense in connection with operating a property, you must decide on the useful life of the property. The method for figuring depreciation is clearly defined by law. Establishing the useful life of a property, however, is a judgmental area. The aggressive tax payer tends to select a short useful life so that depreciation deductions are large. A conservative tax payer, on the other hand, tends to select a relatively long useful life and, as a result, receives a smaller depreciation deduction.

Following an aggressive tax philosophy increases the speed with which you reach your goal of financial freedom. An aggressive tax philosophy is always an honest philosophy

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that simply emphasizes taking advantage of every provision of the law that benefits you.

USING A PROFESSIONAL TAX ADVISOR

Every investor should use the services of a professional tax advisor — either an attorney or an accountant. Professional advisors are trained to recognize legal ramifications with which you may not be familiar. In addition, they usually have access to extensive resources for researching points of tax law that might apply to you as well as extensive training on how to conduct such research.

Of course, you should become personally informed about tax laws in addition to using a professional tax advisor. The combination of your personal knowledge of tax laws and the expertise of your advisor protects and guides you in several important areas:

1. Every day you make decisions which affect your taxes. Your personal knowledge of tax laws will help you know when to seek additional advice.

2. When you are familiar with tax laws, you make more efficient use of your tax advisor by limiting his attention to the most technical points.

3. You can better evaluate the quality of the service your advisor performs for you when you have a good basic working knowledge of tax laws.

4. Advisors often tend to be conservative because they hesitate to risk money belonging to others. When you have a general knowledge of the tax laws, you can provide the aggressive ideas needed to balance an advisor's often conservative approach.

It is important to choose wisely the professional tax advisor who will serve you. Ideally, a tax advisor has degrees in law and accounting as well as a Master's degree in taxation. He should also have attended special courses and seminars given by organizations such as the American Law Institute or the Practicing Law Institute on specialities within real estate taxes.

In addition to the educational and training background of your advisor, a number of other considerations will affect your choice:

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1. *Experience.*

   A tax advisor should possess integrity, knowledge, and experience. Ask how many real estate investors like you he has advised and what experience he has had arguing tax cases in federal court. Make sure your tax advisor is a specialist in real estate tax law for individuals rather than for corporations (unless you use the corporate form of ownership).

2. *Personal rapport.*

   Choose a tax advisor whom you like and with whom you feel comfortable, all other factors being equal.

3. *Tax philosophy.*

   Choose an advisor whose tax philosophy is compatible with yours.

4. *Service.*

   Your tax advisor should return your phone calls promptly, meet deadlines, and be reasonably accessible to you.

5. *Reasonable fees.*

   Discuss the amount of fee with your advisor at the earliest possible moment in the relationship. Ask how much he will charge for the job you need. An advisor may quote an hourly rate, in which case you should ask how many hours he estimates will be required to do your job. Immediately, write a letter stating the dollars per hour he indicated as his fee and his estimate of the number of hours that will be required. In the letter, state also that if it appears the number of hours will exceed the estimate, he is to call you before proceeding.

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6. *Diligence.*

    Your advisor should work hard to help you save money and should fight aggressively for you if you are challenged by the Internal Revenue Service.

TAX SAVINGS THROUGH DEPRECIATION

Depreciation is one of the most important tax provisions for real estate investors. Although your income property shows a profit on a cash basis, taking the depreciation deduction usually allows you to show a loss for tax purposes. Thus, your property income is tax free and part of the depreciation deduction serves as a shelter for other income as well. Four factors enter into figuring depreciation deductions:

1. *Cost Basis.*

    If you purchase a property, the basis includes not only the purchase price, but also such items as escrow, attorney's fee, survey and termite inspection. Be sure not to overlook anything when calculating the depreciation basis.

2. *Improvement ratio.*

    The law says that part of the cost must be allocated to the land and the balance to the improvements. It is to your advantage to place a high percentage of the total cost to the improvements because land cannot be depreciated. In order to determine the improvement ratio, an appraisal of the relative values of the land and the improvements is needed. You may wish to use the services of a professional appraiser for this purpose.

3. *Depreciation method.*

    Four depreciation methods are available to owners of real property:

    200% declining balance method

    New residential property and new tangible personal

property with a useful life of a least 3 years is eligible for this method. New property, as defined in this instance, means that the original use of the property began with you.

150% declining balance method

This method is applicable to new non-residential property and to used tangible personal property with a useful life of at least 3 years.

125% declining balance method

This method is applicable to used residential property with at least a 20-year remaining useful life.

Straight-line method

The straight-line method is required for all other types of property and may also be elected for any of the above properties.

4. *Useful life.*

The useful life of a property is defined as the period of time during which the asset is expected to be useful to you. The useful life for tax purposes is not necessarily the entire physical life.

Assuming the shortest possible useful life maximizes depreciation deductions. In fact, selection of a useful life is one of the grayest of gray areas in the tax law and many disputes in this area end up in court. Consult tax manuals and your tax advisor to choose a good basis for determining useful life. If you choose to be aggressive by choosing a short, useful life, be sure to consider the factors that have determined the disposition of such cases in the courts.

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Figure 7 (page 6) presents the formula for figuring the depreciation deduction. It also shows how this formula was applied to Bob Fisher's rent house. Bob bought a rental house for $125,000 and allocated $25,000 to the land and $100,000, or 80%, to the improvements. He chose to use the 125% declining balance method and assumed a useful life of 20 years. You will see from the application of the formula in Figure 7 that his first year's depreciation allowance amounts to $6,250.

Formula:

$$\text{Depreciation Deduction} = \frac{\text{Cost Basis} \times \text{Improvement Ratio} \times \text{Depreciation Method}}{\text{Useful Life}}$$

Example: Bob Fisher's Rent House

$$\text{Depreciation Deduction} = \frac{\$125{,}000 \times .80 \times 1.25}{20} = \$6{,}250$$

Figure 7: Depreciation Deduction Formula

But Bob could have chosen to use the component method of depreciation. Component depreciation is nearly always better than the composite method. In our example, if Bob chooses the component method rather than the composite method, his depreciation deduction improves significantly. Examine the schedule in Figure 8 (page 7). Notice that the component method assumes a 20-year useful life for the building's structural members only. The 125% declining balance method is used for these items. Other items actually have a shorter useful life and are, therefore, figured on the straight-line method. The result is a total depreciation of $10,502 — an increase of 68% over the deduction figured by the composite method. This represents a sizeable tax saving.

Component	Value	Life	Method	Depreciation Deduction
site prep.	1,400	10	s/l	$ 140
pavement	2,800	5	s/l	560
foundation	4,400	20	125%db	275
fireplace	800	20	125%db	50
rough hardware	500	10	s/l	50
finish hardware	300	10	s/l	30
rough lumber	24,300	20	125%db	1,519
finish lumber	2,700	10	s/l	270
cabinets	5,600	10	s/l	560
insulation	2,600	10	s/l	260
roof	8,100	10	s/l	810
doors	2,500	10	s/l	250
garage door	500	5	s/l	100
windows	1,500	5	s/l	300
stucco	5,900	10	sl	590
wallboard	5,300	10	s/l	530
flooring	2,400	10	s/l	240
carpet	2,700	5	s/l	540
painting	4,400	5	s/l	880
shower/tub	400	5	s/l	80
bath accessories	800	10	s/l	80
built-in appl.	1,900	7	s/l	271
heating	4,600	7	s/l	657
plumbing	9,100	10	s/l	910
wiring	3,500	10	s/l	350
elec. fixt.	1,000	5	s/l	200
total	100,000	total deduction		$10,502

Figure 8: The Component Method of Figuring Depreciation (Using Bob Fisher's Rent House. See Figure 7.)

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The various declining balance methods are also known as accelerated methods because they produce higher depreciation deductions in the early years of ownership and lower deductions in later years. Using the most rapid depreciation method for which your property is eligible enables you to postpone the payment of taxes. Using accelerated depreciation in effect gives you an interest-free loan from the government in the amount of taxes you would have paid had you used the straight-line method.

If you begin using the straight-line method of depreciation on a particular property, you are never allowed to switch to an accelerated method on that property. But if you begin with an accelerated method, you may later switch over to the straight-line method, and there is a point at which you should do so to keep your depreciation allowance as high as possible.

Figure 9 (page 8) shows how to figure the switchover point for changing from an accelerated to a straight-line method of claiming depreciation deductions.

Formula:

$$\text{Switch-over Point} = \text{Useful Life} - \frac{\text{Useful Life}}{\text{Method Factor}}$$

Example:

$$\text{Switch-over Point} = 20\text{ yrs.} - \frac{20\text{ yrs.}}{1.25}$$

$$20\text{ yrs.} - 16\text{ yrs.} = 4\text{ years}$$

Figure 9: Finding the Switch-Over Point from Accelerated to Straight-Line Depreciation.

One other depreciation strategy you may use is extra first-year depreciation, also called bonus depreciation. This deduction is allowed on personal property with a useful life of at least six years and amounts to 20% of the cost up to a maximum of $2,000 per tax payer per year in addition to whichever declining balance depreciation method you are using.

When you sell a property, in addition to reporting any capital gains earned as taxable income, you are required to "recapture" excessive depreciation which you have claimed on the property. In other words, you will refigure all depreciation on the straight-line method and any amounts in excess of that figure which you have claimed in prior years must be reported as ordinary income in the year the property is sold.

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TAX SAVINGS THROUGH INSTALLMENT SALES AND EXCHANGES

If you plan to sell a property on an installment sale, investigate the current tax rules surrounding the treatment of installment sales. An installment sale is any sale in which you receive some portion of the payment after the year the sale takes place. That means you pay tax on the capital gain as you receive principle payments on the loan you made to the buyer.

Installment sales are extremely complex and applicable laws are subject to change. If you intend to engage in installment sales, be sure that your tax advisor understands all the ramifications and is prepared to assist you in determining how such sales will affect your tax standing.

For any number of reasons, you may decide that you no longer wish to own a particular property. You can sell the property and purchase another, paying the applicable capital gains tax, or you can accomplish the same purpose of moving from one property to another without paying any tax if you make a tax-deferred exchange.

Like the installment sale law, the law regarding property exchanges contains complicated requirements. It is extreme-

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ly important that you have an excellent tax advisor when you make an exchange, and it is important that your advisor be involved from the very start.

The most common exchange is a three-way exchange. Look at Figure 10 (page 11) as you listen to this example. Assume that A wants to acquire B's property by exchange. B wants to sell, but is not interested in owning A's property. A finds a buyer, C, and agrees to exchange this property to B in return for B's property, at which time B will immediately sell A's former property to C.

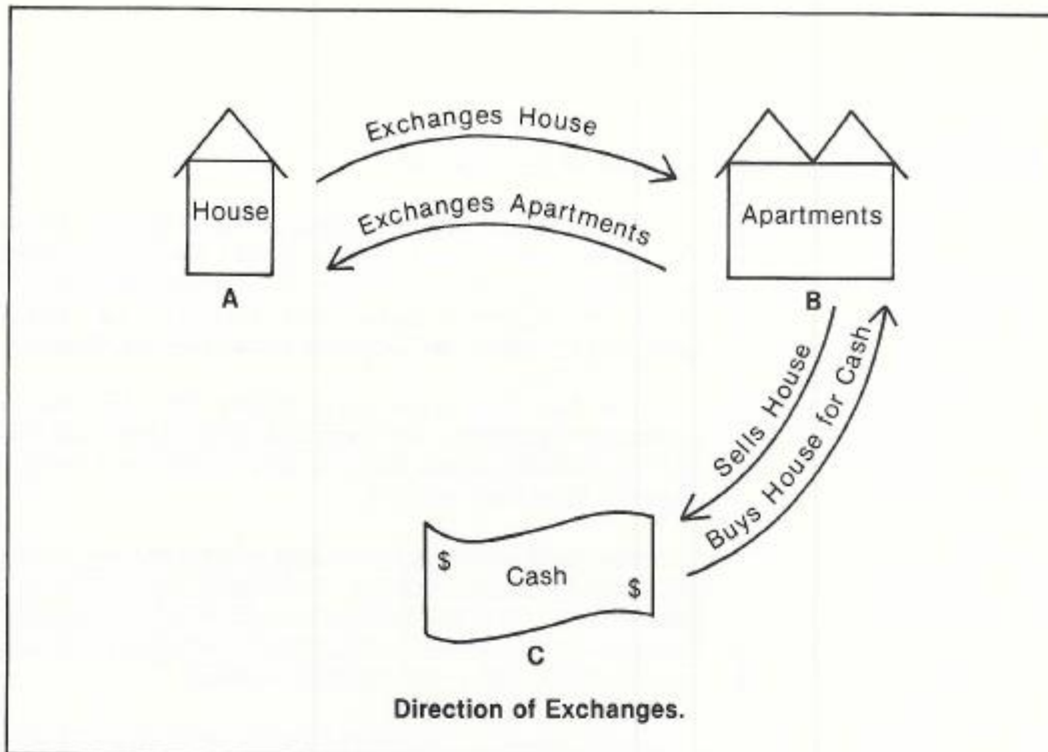
In such a transaction, A and B exchange properties; B sells A's property to C. A now owns B's property. B has cash from selling A's property to C. C owns A's property. A did not pay tax on the gain he realized on his old property since he merely exchanged. C, as a purchaser, doesn't pay tax. B will pay tax if he has a gain, but would have done so had he simply sold the property.

Exchanges are extremely important because they allow you to defer all taxes. In fact, you can exchange for your entire life and never pay taxes on your gains.

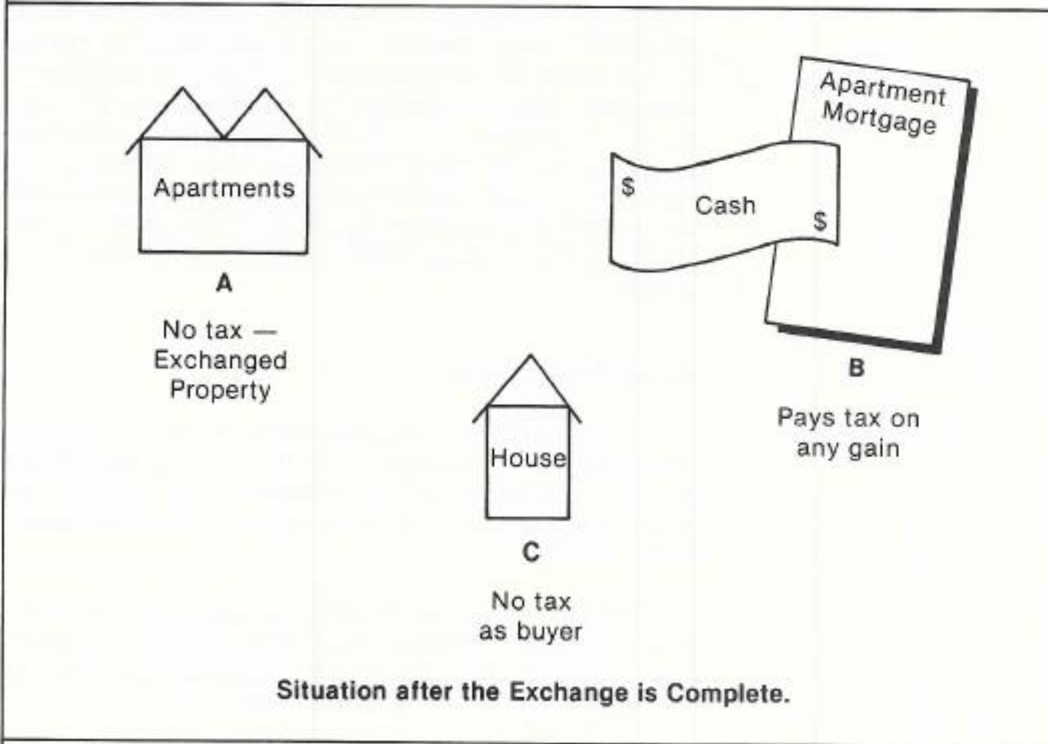
DEALER STATUS

Dealer status is one of the gray areas of tax laws. The advantages of tax-deferred exchanges, depreciation and long-term capital gains are lost if any transaction is declared a "dealer" transaction. This designation attaches to the *transaction* rather than to the *individual,* although when you have participated in previous dealer transactions, there is a tendency for the IRS to view new transactions in this light also.

The basic philosophy upon which dealer status rests is making a change in the purpose of property, such as subdividing land into residential lots or converting residential property into offices or other commercial uses. You and your tax advisors should be familiar with related court cases to have a feel for what the courts have and have not allowed.



Direction of Exchanges.



Situation after the Exchange is Complete.

Figure 10: How a Real Estate Exchange Works

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OTHER TAX BREAKS

From time to time, Congress provides special depreciation allowances to such properties as low-income housing and historic properties. Check all available tax references and consult with your tax advisor to make sure you are taking advantage of every tax break for which you are eligible.

The law says you may deduct the "ordinary and necessary expenses" of doing business. When you fill out your income tax return, be sure to consider every deductible expense you have incurred.

Real estate investors are also eligible for various travel and entertainment expense deductions. For example, you may deduct the cost of travel to look after your properties. Entertainment deductions require accurate, thorough records: who, what, why, when, how much.

A tax credit is deducted directly from your tax liability rather than from income. If you are in the 50% tax bracket, a *tax credit* is twice as valuable as a *tax deduction*. Tax credits are provided to encourage certain types of behavior or investments. One investment tax credit encourages the purchase of business equipment, while another promotes the rehabilitation of older, non-residential buildings. Energy credits encourage conservation of energy and substitution of non-petroleum fuel sources. Stay up to date on current credits and take advantage of all those for which you are eligible.

YOUR OBJECTIVES

How aggressive or conservative a tax philosophy you adopt will depend on what is comfortable for you. Most people who choose to be ultra-conservative probably do so because they and/or their advisors are fearful of the entire tax system.

The fact is you will never go to jail unless the IRS can prove that you committed fraud. Of course, you do not intend to do any such thing. You can be required to pay back taxes plus interest of 12% — which is deductible — if you claim a

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deduction which is later disallowed. Always be aggressive, honest, and thorough in figuring your taxes. It is your right as a citizen to pay only those taxes which the law requires you to pay. It makes sense to take every deduction to which you believe you are entitled.

Your right to take advantage of every legitimate method of saving taxes was upheld long ago in the U.S. Supreme Court. It is fitting that the tax payer and the tax collector are occasionally adversaries in gray areas. Fight the good fight. Pay your taxes and interest if you lose. And celebrate if you win.*

This week check the progress you have made toward achievement of your **Financial Freedom Goals.** Indicate on each **Financial Freedom Goal** form the date that specific actions were taken. Determine whether you are on target. If you are behind schedule, let this progress check serve as added motivation to take action this week. List on your calendar the specific activities you must accomplish to get yourself back on target toward achievement of your goals. If your progress has been satisfactory, take time to celebrate your success. Enjoy the *process* of goals achievement as well as the *results.*

*For additional information on tax matters, see the references listed in Appendix A behind the last tab sheet in this manual.

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