

REALESTATETAXLAW.COM TAX & ASSET PROTECTION NEWSLETTER FOR REAL ESTATE INVESTORS

December 1, 2008

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THE “AVOIDING REDISTRIBUTION” ISSUE

Social Security Taxes Will Change But Have Some Hope!

Prepare for change, starting with a high likelihood that social security taxes (aka self-employment taxes) will go up dramatically via lifting of the “social security cap”.

Social Security Tax Defined

Social Security tax is only levied against “earned income”. Earned income is generally defined to include any type of income except:

- Rental Income
- Interest income
- Dividend income
- Capital Gains
- Royalty Income

Generally, if you are selling services (e.g. – realtor, tax advisor, etc.) or inventory (e.g., “dealer” property, flips, rehabs, assignments, and simultaneous closings), your income from those sources is subject to social security tax. At present, social security tax is approximately 15% of “earned income” up to the first \$100,000 per person. After the first \$100,000, the tax rate drops to 3%. For example, a taxpayer making \$190,000 of earned income would pay \$17,700 ($(\$100,000 \times 15\%) + (\$90,000 \times 3\%)$) in social security taxes. If the “\$100,000 cap” on the 15% bracket were lifted, as proposed by President Elect Obama, the \$190,000 in earned income would generate an income tax of \$28,500 ($\$190,000 \times 15\%$), resulting in a \$10,800 tax increase.

Taking the Bite Out of Change

First, the Bad News: If you are a W-2 employee, you are stuck with the increase.¹ Now the Good News: If you are in business for yourself, we can reduce the bite. Here are two good techniques to do exactly that:

1) Form an S-Corporation or Limited Partnership: Earned income that passes through an S-Corporation or LP is exempt from social security taxes.

- Tip: You will need to pay a “reasonable” salary out of either company, and that salary is subject to social security taxes. As such, our object is to keep the salary as low as reasonably possible, while the IRS’ goal will be to maximize it. To justify a reasonably low salary, you will need to

¹ I’m quite certain that taking money from consumers in the midst of a recession will help the economy. After all, no one will reduce their spending because they have less cash to spend.

track your hours and figure what someone doing comparable work would be paid in the open market.

- Tip: It is easier to decide how much salary to pay in late November early December, once you can tell how the company is doing for the year.² Also, paying the salary in one or two lump sums will cut down on payroll company fees.
- Tip: S-Corporations are cheaper and easier to run than LP's. They are also less flexible and much more likely to be audited than LP's. For small, new, single-owner operations an S-Corporation usually makes sense. For larger operations, those with significant profits or those with partners, an LP is probably worth the extra time and hassle. We do provide assistance with selecting, creating and maintaining entities.

2) Convert earned income to non-taxable (for social security tax purposes) income: For example, a flipping business that has an office in one of your properties might pay the property owner rent. The rent expense reduces the flipping income, which is taxable for social security tax purposes, and increases rental income, which is not taxable for social security tax purposes. Likewise, capitalizing the flipping company with debt and paying interest on the debt would reduce the flipping company's highly taxed income while increasing interest income, which is exempt from social security taxes.³

- Tip: You cannot just "make up" a rental rate or interest rate. The rents or interest that you charge yourself need to be at "arm's length" prices, meaning at prices close to what the market would charge a third-party in similar circumstances. The IRS has great power to reject or modify unreasonable rents, interest rates, "consulting fees" and the like. Use common sense.
- Tip: The flipping company must actually pay the rents or interest, preferably the same way a regular renter or debtor would. The less the payments between related companies resemble "how it's done in the real world", the less likely they will pass muster with the IRS. Most companies pay once per month (and not once per year or whenever they feel like it), and all pay with check, electronic transfer or credit card. Just making an accounting entry that one company "owes" the other for "rent" or "interest" is a prescription for an ugly and expensive audit.

Action Items to Reduce Social Security Taxes Before the O-Bomb-a Goes Off in 2009

- Set up an S-Corporation or Limited Partnership
 - You will want the company in place before January 1, 2009
 - We can assist with choosing and creating the entity
- Towards the end of the year, determine and pay a reasonable salary
 - We can help you determine a "reasonable" salary
 - We can also direct you to a solid payroll processing company
- Convert social security taxable income into more favorable rents, interest, etc.
 - We can help document "arm's length" prices

Purchase Rebate Loophole – Reduce Taxable Income by \$30,000+

² If your books are not good enough to give you a picture for the year, you really want to think about acquiring our KISS Guide to RE Bookkeeping for yourself or your bookkeeper, see our Products page at www.realestatetaxlaw.com. If your books are really, really poor, you may want to call us for help at 614-207-2441.

³ Bear in mind that companies that have "too much" debt capital and "too little" equity capital may be disregarded (pierced!) for asset protection purposes as "too thinly capitalized". Asset protection requirements are often at odds with tax planning, careful balancing is required.

I have seen a fair number of purchases where the price paid for a property on the HUD-1 (closing statement) is not the same as the amount ultimately paid for the property. For example:

Buyer purchases a property for \$100,000 and has a “side deal” to receive a \$30,000 rebate from Seller outside of closing. The sales number that will appear on the HUD-1 is \$100,000, even though the buyer is really only paying \$70,000 after taking the \$30,000 rebate into account. From the standpoint of the buyer, many accountants would treat this transaction as a \$100,000 purchase, followed by \$30,000 in taxable income. Such treatment is harsh (\$30k in taxable income!) and likely incorrect. In a court case called *Freedom Newspapers, Inc. v. Commissioner of Internal Revenue*, a payment made to the taxpayer to induce it to purchase a property was treated as a reduction in the basis of the property purchased, and not as income. In our example, that would mean that the purchase price of the property in our example would be treated as \$70,000 with no income resulting from the \$30,000 rebate. The logical corollary of a reduced purchase price is a reduced sales price of \$70,000 for the seller. NOTE: Side deals outside of closing are often a sign that any bank involved is being given the “mushroom treatment” - that is, fed manure and kept in the dark. Such tactics could easily rise to the level bank fraud and are not a practice that we recommend. Nonetheless, for those of you who have been involved in such a transaction as a buyer or seller, the purchase/sale price reported to the IRS should reflect economic reality, and not necessarily what is on the HUD-1. When dealing with the IRS, what happened in reality generally trumps what is written on paper.

Another example of where the *Freedom Newspapers* case might help us: I have a number of clients who buy properties in the GO-Zone and receive loan forgiveness on certain of those purchases. Let me explain what that all means:

- Properties purchased in certain areas ravaged by Hurricane Katrina (e.g. certain counties in Mississippi and Louisiana) may be eligible for a 50% “bonus depreciation” deduction in the year purchased, also known as “Gulf Opportunity Zone” or “GO-Zone” depreciation. For example, a qualifying \$100,000 property could easily give rise to a \$50,000 deduction in year one (that’s in addition to the usual deductions for interest payments, utilities, etc.), and more normal deductions in subsequent years.
- Government grants: Some of the properties in the GO-Zone can also qualify for government grants. From what I’ve seen, the grant is designed to promote a reasonable limitation on the amount of rent charged to people in certain income groups. In exchange, the government will pay 30% of the loan on the rental property after 1 to 5 years. Following our example above, let’s assume that the granting agency cuts the property buyer a \$30,000 check in year 5. Based on the *Freedom Newspapers* case, we would reduce the property’s tax basis (investment in the property for tax purposes) by \$30,000 – resulting in cash but *no extra income tax*.
- To reiterate:
 - A \$100,000 GZ property could easily result in a tax write-off of \$50,000 in the year purchased, in addition to the usual write-off’s one would expect with a rental property AND
 - If the property is covered by a local grant program, the taxpayer could receive \$30,000 cash – tax-deferred or tax-free.
 - Upon request, we can put you in touch with sellers of such property, along with grant-money specialists.
- Action Item:
 - Review your deals. If any of them had numbers on the HUD-1 (or other documents) that did not reflect the economic reality of the transaction, see which numbers made it to

your tax returns. If the “paper” numbers are what was reported to Uncle Sam, then consider amending your tax returns to show the “real numbers”.

- Going forward, you now know how such deals should be reported. If your current tax advisor is not up to speed on such reporting, kindly consider switching advisors.

Last-Minute Year-End Planning

- Run a profit and loss/income statement and review your income for the year
- Check up on how much you’ve paid the IRS and state taxing authorities for the year. Compared to your income, have you paid enough to avoid withholding penalties? If not, what is the consequence of not paying more into the system?
- If you have an S-Corporation or Limited Partnership, have you paid a “reasonable” salary for the year?
- Have your entities had annual meetings, recorded resolutions and followed other formalities required to maintain the existence of the company?
- While you can make 2008 payments into IRA’s, Roth IRA’s and other exempt accounts for 2009, such accounts must generally be established by the 2009 year-end. Waiting until the very last minute to create such accounts often results in a failed transaction, we’d work on that now.
- We are of course willing to help with any of the above items, in exchange for a fee!

Starting 2009 the Right Way

- 2009 promises to be an interesting year. There will be continued opportunities to buy bargains. There will also be many challenges in the form of a rough economy and a changing tax environment. To that end, we are offering a three day workshop in Columbus, Ohio from Friday January 9th through Sunday January 11th. Among other items, we will spend three solid days (in other words, this workshop will NOT be a “sales fest”) covering:
 - Proper structuring and care of entities for asset protection and tax savings;
 - Record-keeping and book-keeping to audit-proof your business (audit rates are going up....somehow the government has found itself short of money!);
 - Focused tax planning for REI, including “dealer” issues, tax-free/1031 exchanges, maximizing meal and entertainment write-offs
 - What we’ve seen on audits of sub2 clients,
 - Lease options – what your accountant missed
 - Short sale tax savings for your sellers, including overcoming objections on the tax side of things;
 - What sorts of issues get REI in trouble (e.g. the infamous “trip and fall”, consumer laws, etc.) and how to avoid or win such lawsuits;
 - What I’m seeing my successful clients do in the present RE marketplace;
 - And much, much more;

For more information and details, please see the enclosed flyer or go to:

<http://www.realestatetaxlaw.com/start-the-new-year-right-workshop.pdf> . Happy investing, Merry Christmas, Happy Holidays and may the IRS audit your mother-in-law!