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PROTECTION NEWSLETTER FOR REAL ESTATE
INVESTORS

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THINGS YOU NEED TO DO NOW

I love being an entrepreneur, just as I love working with entrepreneurs. However, if I have gripe about entrepreneurs, and most especially a gripe about REI, it is that they tend to procrastinate on admin and back-office issues. “Today” becomes “mañana”, and “mañana” becomes “never”. If you not willing to take certain simple (if annoying) actions NOW, then just skip this article, for it will simply vex you without accomplishing anything worthwhile. My three suggestions for starting the tax year right are:

- 1) Keep Excellent Books
- 2) Track Your Mileage; and
- 3) Track Your Time.

Keep Excellent Books

I cannot over-emphasize the importance of having accurate books, meaning an income statement by property and a balance sheet by property. Keeping excellent books:

- Gives you an accurate picture of what your business is REALLY doing. If you do not have such information, you are bound to make costly errors – and you WILL, for you are NOT “different”. I see it over and over, bad decisions made based on flawed information. Does the term “CIA” ring a bell?
- Makes tax preparation cheaper and more accurate;
- Makes an audit less likely and MUCH cheaper if it does occur; and
- Makes your entities more likely to stand scrutiny.

Here is an Immodest Proposal (Where’s Jonathan Swift when you need him?): Our *Kiss Guide to Bookkeeping* (available at www.realestatetaxlaw.com) is a very cost-effective solution to producing excellent books for REI via QuickBooks. Can’t find the time to do it yourself? Buy the course, hand it to an accounting intern (ten bucks per hour will make most of them quite happy) and have our firm periodically look over the intern’s shoulder.

January the First is the perfect time to start-over on your books. The reason: most companies’ income and expenses reset to zero on December 31, so there is no need to “go back” and enter income data from earlier in the year. Every day that passes makes that “fresh start” harder. Meaning, don’t wait, DO IT NOW.

Track Your Mileage

Technically, you are supposed to track the amount of time that computers, printers, phones and cars (among other things) are used for respective business and personal purposes. As a practical matter, I do not track the time on my computer (the time it takes to track is not worth protecting the tax deduction involved) or on my cell phone (because I can go back and figure out which calls were business-related by checking the phone bill if pressed hard in an audit). I DO track my car mileage religiously for four very good reasons:

- 1) The dollars add up quickly. The sheer size of the deductions most REI take for mileage driven or actual expenses incurred (you *must* track miles under either method) definitely justify the hassle involved.
- 2) This is a major audit item for the IRS. It comes up frequently.
- 3) A little box on your return asks if you tracked the expenses and mileage in writing. If you check “no” or ignore the little box, you are screaming “audit me!” If you check “yes” and are later proved to have not properly documented the mileage, you have committed civil fraud, because you represented that you did a thing and in fact did not do that thing. The penalty for civil fraud is **75%** of the tax avoided, plus interest.
- 4) The IRS will NOT take your word for it. Also, if you drive one car 100% for business and another 100% for personal use, the IRS does not care, you need to prove the 100% mileage. Even if the business car is owned by a stupid personal property trust that has a stupid Nevada C-Corporation as the owner. Really.¹

What’s more, tracking mileage takes a bit of discipline and little time. Here’s an easy approach:

- 1) Write down the miles of your odometer on the first of each month.
- 2) Subtract (for example) the January first reading from the February first reading to derive the total amount of miles driven for January.
- 3) Track your business mileage in detail for one week per month. The more detail and the less rounding, the better. Track ALL of the business mileage – trips to your properties, trips to eat those deductible business meals, trips to buy supplies, trips to wage class warfare on/collect rent from tenants, EVERYTHING.
- 4) Prorate the *business* miles driven for the week to the *total* miles driven for the week. That means you need to read the odometer at the beginning and end of the week.
- 5) Now apply the mileage percentage to the miles for the entire month. For example, if 78.56% of the miles driven for the “tracking week” were business miles, then multiply the total miles driven for the month by 78.56% to derive the business mileage for the month.
- 6) I would pick the 2nd complete week of each month as “the week”. Reasoning: That is the week with the fewest holidays and the week most likely to involve the most business driving.
- 7) Stating that a vehicle was used “75%” or “90%” or “pick a round number” for business is a dead giveaway that you are, umm, fudging, to put it politely. If you absolutely must “fudge”, learn from the best, do it well.² Hint: Fudging like Bleeping Blagojevich B-A-D, fudging like our One True Savior and President Elect, the only clean politician in the history of Chicago, not-quite-so

¹ If you are using personal property trusts and Nevada C-Corporations, there is a strong likelihood that you are overcomplicating your business. For most small-to-medium REI, the direct and indirect costs of such structures do not begin to justify the true benefits. I see it time and time again; you can always tell when someone bought the four or five figure package from some Nevada “asset protection specialist”, which is a fancy way of saying “non-lawyer with serious sales talent”. Oh, but wait. Your non-lawyer guru TOLD you that your lawyer and accountant would pooh-poo the idea because they just do not understand. If you think that a non-lawyer with something to sell knows more on the subject of taxes or asset protection than your friendly neighborhood Attorney/Accountant/REI (meaning “me”), then I have some excellent Florida properties to sell you. Yes, I’m ranting. Pet peeve, sorry.

B-A-D. In short, be convincing, avoid substance and get the media to make swoony cow eyes at you when entering round numbers for auto mileage, or better yet, do not enter round numbers....or best of all, actually track the miles.

Track Your Time

For REI, I can think of at least two reasons to track your time:

- 1) Real estate Professional Status: For many REI, the tax benefits of owning rental properties are limited unless the REI qualifies as a "RE professional" under Section 269(c)(7) of the Internal Revenue Code. To qualify as an RE Pro, a taxpayer must demonstrate that he³ has:
 - a. Spent at least one-half of his "working" time in a real property trade or business; and
 - b. Spent at least 750 hours in a real property trade or business; and
 - c. Has materially participated in the rental activity, which usually means 500 hours of "hands on" time.
- 2) Determining "Reasonable Salary" when using an S-Corporation or Limited Partnership to reduce social security/self employment taxes (see the December 2008 issue of this newsletter for more on that topic).

Both of these planning techniques are being heavily audited by the IRS, and in both cases they will not "take your word for it". If you want to preserve the planning technique, you need to track your hours in a convincing and credible manner. By taking five minutes a day, you should be able to accurately document what you did with regard to RE for that day. If you procrastinate, your memory will fade, and your log will show suffer in terms of credibility. Detail helps. For example, writing the names of the exact persons or addresses dealt with, and in what capacity helps add weight to a story (e.g., visited 24 units in Greenridge Estates Mobile Home Community from 9:10 am to 4:46pm on January 5, minus ½ hour for lunch, to collect rents, post violation notices, inspect the park, review two rehabs in progress, spent 2 hours and 10 minutes driving there, etc.) Individualizing each entry, instead of just cutting and pasting old entries, adds authenticity. Likewise tracking the exact time spent, as opposed to simply rounding, tends to make an entry more believable. Any "generic entries" or "repeat entries" (I must emphasize that I do not care for either, but those are better than nothing) should also be credible. For example, claiming that paying bills took an hour, if the bills were in fact paid with three checks, would kill one's credibility in front of an auditor. Likewise, claiming that paying the bills always takes the same amount of time reduces the chance that a narrative will be believed. In short: Track daily for five minutes, include details and do not clone entries. If People Magazine can count the vast number of "nocturnal visitors" Paris Hilton has entertained, you can surely count the hours spent on RE in a convincing manner!⁴

² I am certainly not recommending that you fudge. Idiot politicians, simpleton juries and slick shysters are the reason I actually have to add this sort of footnote to clarify what should be painfully obvious to even the sub-morons amongst us.

³ I generally follow the older, misogynistic rules of grammar, the same ones founded by those Evil Dead White Men. It results in smoother English and annoys all the right people.

⁴ For those of you inclined to view that statement as "sexist", I have two suggestions: First, substitute the name of some male bubblehead (almost any Hollywood personality possessed of Y-chromosomes will do) for "Paris Hilton" and second, stop reading my newsletters, for they shall surely grow increasingly obnoxious.

LEASE OPTION TIP

Most lease-option investors know that option consideration received is treated like a deposit on a rental – that is, treated as a loan to the REI initially, and treated as income once the REI is allowed to keep the option consideration with no obligation to pay it back (e.g., options are treated as income once they expire, are forfeited or are exercised). Most REI (and their accountants!) do not know that the “character” of an option is determined by the underlying asset. For example, if I lease-option a rental property to a tenant-buyer, the character of the option consideration is usually that of a capital asset, just like the underlying rental property.⁵ As most of you know, a capital asset that is held for more than one year is subject to favorable long-term capital gains rates of 15%. So, if the tenant buyer were to default on the lease-option after 53 weeks (in other words, after more than a year), the option income would be reported as a long-term capital gain and taxed at only 15%.⁶ If I had a nickel for every time I’ve seen option consideration reported at higher “ordinary” income tax rates, as opposed to the lower, better capital gains rates....

THREE MORE LAST MINUTE ITEMS

- The IRS requires that you send Form 1099, reporting income that you paid to contractors and other persons, by January 31.
- The IRS requires that you send Form 1098, reporting interest received on notes, by January 31.
- For many of you (especially if you are not withholding enough via W-2’s), this January 15th is an important withholding/payment date.
- Capitalists that we are, our staff would be happy to assist you in preparing and filing those 1098’s and 1099’s, or calculating proper withholding amounts, all for a very reasonable fee, of course.
- Which reminds me, we ARE taking clients – and no client is too small. Oddly, many beginners or REI with one or two units assume that we are not interested in them. I say – your money is as good and green as Trumps’ and you will find our fees quite reasonable. Contact us! Information about us, including our contact data and several useful (not to mention offensive....) articles can be found at www.realestatetaxlaw.com.

THIS MONTH’S REAL DEAL

At least every few months, I’d like to include a brief description of at least one deal made by one of our clients in this newsletter. This month’s entry is atypical, in that you probably know the client in question. Specifically, I had the chance to spend the better part of a day with Vena-Jones Cox in Cincinnati. Many of you would be familiar with her as a mentor, teacher and writer. Unlike all too many teachers, Vena *actually does what she teaches*. I would know, since my firm prepares her tax returns, helps with her bookkeeping and provides her with tax planning advice. In short, I’ve been behind the

⁵ For the very, very technical types out there, a rental property could be considered a “Section 1231 Asset”, as opposed to a true “Capital Asset”. The result would be the same in our little example. I chose not to try and explain all of that to my layman readers at this time – and they are doubtless grateful for having avoided such soporific details. If it actually occurred to you to “correct” my loose use (it rhymes!) of the term “capital asset” before reading this footnote – you need to lighten up, hide the sharp objects, take a deep breath and have yourself a gallon or so of Bombay Sapphire. I recommend the use of a funnel for the latter.

⁶ This example does assume that the option contract was properly drafted to last for more than a year. If the option contract automatically expires and renews after 12 months, the REI could never “hold” it for more than a year, by definition.

curtain – and I liked what I saw enough to write about it. Her approach should be of interest to both wholesalers and buy-and-hold investors.⁷

After socializing and covering some tax-related business, we went out and looked at some of her properties. She keeps some of the properties as “buy and holds” and wholesales others. The criteria used to acquire either type of property are the same, based on a time-tested formula:

- A reasonable and current fair market value backed by reasonable and current comps;⁸
- Multiplied by 70% (60% for low income properties in “rental” neighborhoods);⁹
- Less costs of repair;
- Less her profit.¹⁰

A note on repairs: Vena is big advocate of “stabilizing” a property and is also a pretty shrewd judge of the correct cost of repairs. If there is any doubt as to whether an item needs repaired, she will repair it. Watching her argue with business partner Drew over what to repair is fun and not for the weak of heart. We are talking about pitching 2-year old windows and 5-year old furnaces that most landlords (including your author) wouldn’t have dreamt of replacing. She wants a rental to be near-perfect. Here’s why:

- Low income tenants in particular are very sensitive about utility costs, including furnace efficiency and leaky windows;¹¹
- Management hassle, time and expense are significantly reduced;
- Superior properties attract superior tenants who pay, stay and don’t call;
- Operating expenses, as a percent of gross income, are quite low (@20%), making for nice cash flow;
- Potential liability is reduced;
- Initial repairs can be financed into the deal, whereas ongoing repairs come from cash flow;
- I’m sure she has more reasons that I’m omitting.

⁷ I am not receiving anything from Vena for writing this article, except perhaps warm-fuzzies. In short, I respect her and recommend her as a teacher and as a wholesaler of RE. Please do not ask me write something about you, as I will almost certainly say “no” (even if I like you) and needlessly upset you.

⁸ I cannot overstate the importance of beginning with reasonable and current FMV. I have seen countless “wholesalers” use inflated or otherwise optimistic figures as their starting point for FMV, rather like the jewelers who mark the “retail” price of a ring up before “discounting” it. The corollary: I have seen many buyers of “wholesale” deals end up with a real dogs. There is NO substitute for doing your own due diligence, regardless of with whom you deal. The Gipper said it: Trust, but verify. Oh, for the days when Republicans were both articulate and conservative.

⁹ In some low-income neighborhoods, it is impossible to get real comps, as all of the properties for sale are foreclosures. In such cases, Vena reverse-engineers a price that results in \$200/month cash-flow (before management fees, most of her buyers manage their own properties), based on 100% financing at 8% and conservative (meaning “high”) rehab costs. I use a very similar approach on the small mobile home parks I buy.

¹⁰ I know “The Number”. But you will have to ask Vena to tell you, I won’t. Tax advisors who talk too much get fired.

¹¹ If low income tenants get it, we probably do not need Al Gore running a supra-national agency with police powers and post-office like efficiency to be reasonably green. Silly watermelon, green on the outside, red on the inside!

Another facet of Vena's wholesale business that I liked: Her own property manager, personally trained by her,¹² will manage properties sold by Vena for a reasonable fee. What's more, he will manage low-income properties and seems quite good at it. An honest and competent manager who also deals in low-income properties (Vena wholesales more than just low-income properties, though that category is my own personal favorite) is exceptionally rare. Having met him and seen how Vena's properties are managed, I was favorably impressed.

Here is a real, recent example:

- The property is on Westknolls in Cincinnati (exact address withheld because someone on my mailing list bought it from Vena to hold as a rental);
 - I saw this property (bank owned) before Vena acquired it. We were not able to get in. From what I saw through the windows, the inside looked to be in good, clean shape. The exterior was solid and clean.
- Gross rent was estimated at \$795;
- Property tax will equal \$42.58/month once assessment is reduced to match purchase price;
- Operating expenses = 20% of \$795 or \$159 (remember, property is stabilized with heavy rehab);
- The property needs to cash-flow \$200/month, so the amount available for a mortgage =
 - +\$795 gross rent
 - -\$42.58 property tax
 - -\$159 operating costs
 - -\$200 cash flow
 - \$343.42 available for mortgage payments
- Barring any other adjustment, \$343.42 at 8% over 30 years will support a mortgage of \$47,114.
 - BUT we have to take into account \$13,000 of repairs (Vena's estimate to "stabilize") AND her profit margin of \$7,000 on this property, so the target purchase price = \$27,114 (\$47,114 mortgage less \$13,000 repairs less \$7,000 margin for her).
- Her actual purchase price was \$25,500. She sold it on land contract for \$48,900 (including rehab funds for buyer built into the LC), 8% interest, \$9,900 down. Knowing Vena, her underlying financing was probably @ 8% via private lenders. Roughly speaking, she is doing a bit better than break-even on payments and pocketed her profit with the down payment. Her buyer has a property in very good shape that is likely to cash-flow as advertised, with built-in financing.¹³ Had Vena kept the property as a buy-and-hold, she would have cash-flowed @ \$225 - \$230/month with fairly low management hassle based on excellent condition of the property.
- Either way, this deal strikes me as a good wholesale or a good buy and hold – and this was only one of several that she was working on.

If you are interested in contacting Vena for to acquire a property or use her manager, email her at Drew@RealLifeRealEstate.com.

For more information on how to do what she does, try TheRealEstateGoddess.com.

¹² Unless you've met Vena and BS'ed with her for a bit, you have no idea as to the amount of meaning contained in the three words "trained by her".

¹³ As is always the case, I have little doubt that a cash sale would have resulted in a lower price.