Tax Planning:
Rental Real Estate

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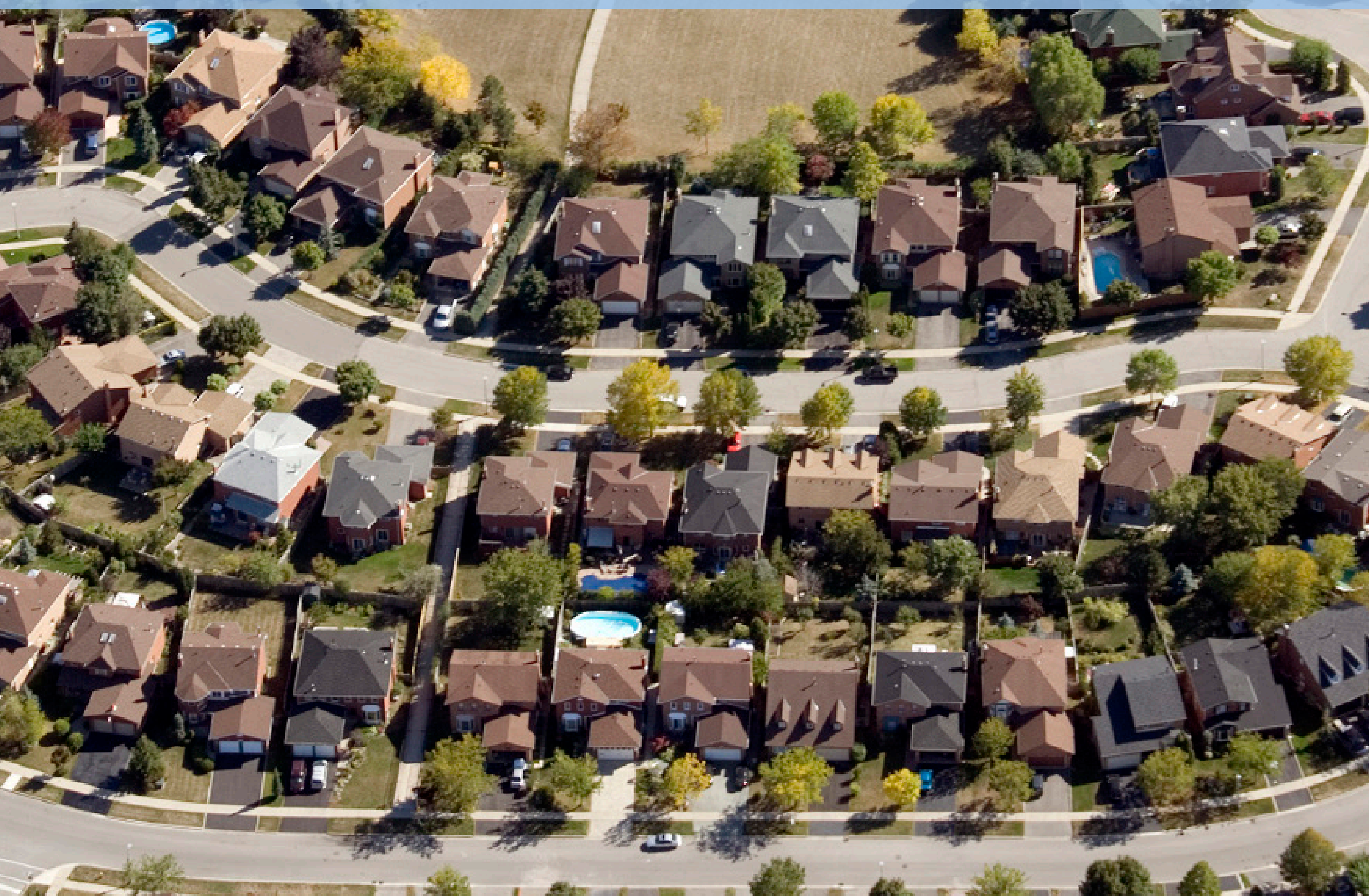

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THE WOLFE LAW GROUP

The Wolfe Law Group is an international array of legal and tax experts providing collaborative services for Global High Net Worth Investors on a per client basis.

Gary S. Wolfe, A Professional Law Corporation has over 35 years of experience providing clients with expertise for IRS Civil and Criminal Tax Audits, International Tax Planning, and International Asset Protection.

Awards
Since 2015 Gary have been the recipient of 29 separate international tax awards from 10 different global expert societies in London/UK including:

International Tax Planning Law Firm of the Year Award (2017) – International Advisory Experts.

International Tax Advisor of the Year (2017) - Global Business Magazine/Prof. Sector Network.

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Books
To date Gary has written 18 e-books (available on Amazon) regarding the IRS, International Tax Planning and Asset Protection. Click here for complete list.

Articles
To date Gary has published or been interviewed in 100+ separate articles published by 15 different US and International magazines. Click here for complete list.

Video
In December 2016 Gary was interviewed by California CEO Magazine and RCBNNews.org on the subject of Criminal Tax Evasion and IRS Tax Audits: Civil and Criminal Issues. This 4 part series, which has been published by Lorman Education, can be viewed below:

Criminal Tax Evasion - Part 1
Criminal Tax Evasion – Part 2
Criminal Tax Evasion – Part 3
Criminal Tax Evasion – Part 4

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Tax Planning: Rental Real Estate

Under IRS Publication #527(2)(p.5) a Taxpayer may the recover the cost of income-producing property though yearly tax deductions by depreciating the property (i.e. by deducting some of the cost each year on the taxpayer tax return).

Three factors determine how much depreciation can be deducted each year:

1) Taxpayer basis in the property;
2) Taxpayer recovery period for the property; and
3) The depreciation method used.

According to the IRS Pub. #527: “you cannot simply deduct the mortgage or principal payments, or the cost of furniture, fixtures, and equipment, as an expense (for rental property). You can deduct only on the part of your property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

Since Taxpayer did not previously depreciate the cost of the improvements or the capitalized expenses added to basis under IRS Pub. #527 there was no reduction for the basis (for prior depreciation taken) on the 2016 sale.

Under the US Supreme Court Case Gregory v. Helvering 293 US 465 (1935) the Court held that the doctrine of substance over form is for Federal tax purposes, a taxpayer is bound by the economic substance of a transaction where the economic substance varies from its legal form…however, the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted.’”

Legal Authority

IRS Publications 527 (Residential Rental Property) and 551 (Basis of Assets) define the basis of property for calculating a taxpayer’s capital gain on sale.

Under IRS Publication 551 basis is the amount of investment in property for tax purposes. Property basis determines depreciation, amortization, depletion and casualty losses. In addition, it determines gain or loss on the sale or other disposition of the property.

The basis of the property is its cost. Other costs related to buying or producing the property are capitalized i.e. added to basis. The original property basis is adjusted (increased or decreased) by certain events e.g. improvements to the property increase the basis; deductions taken e.g. Depreciation or casualty losses reduce the basis.

The basis of property purchased is its cost. The cost is the amount paid in cash, debt obligations, other property or services. Costs include amounts paid for the following items: sales tax, freight, installation and testing, excise taxes, legal and accounting fees (that are capitalized) recording fees and real estate taxes (if the buyer pays them on behalf of the seller).

Real Property (i.e. Real Estate) is both land and anything built or attached to it. There are specific categories of expenses that may become part of the cost basis including:

1) Real Estate Taxes: If the buyer paid real estate taxes owed by the seller and was not reimbursed, taxes paid are added to basis and cannot be deducted. If the buyer reimburses the seller for the taxes the seller paid for the buyer, the buyer can deduct that amount as an expense in the year of purchase. If the buyer does not reimburse the seller, the buyer must reduce their basis by the amount of those taxes.
2) Settlement Costs: Buyer's basis includes the settlement fees and closing costs for buying property. Buyer cannot include in their basis the fees and costs for getting a loan on the property.

   The following items are some of the settlement fees or closing costs which buyer can include in the basis of the property purchased:

   - abstract of title fees, charges for installing utility services. Legal fees (including title search and preparation of the sales contract and deed), recording fees, surveys, transfer taxes, owner's title insurance, any amounts that the seller owes that the buyer agrees to pay e.g. back taxes, interest, recording or mortgage fees, charges for improvements or repairs and sales commissions.
   - Settlement costs and fees not included in the property basis: casualty insurance premiums, rent for occupancy of the property before closing, charges for utilities or other services related to occupancy of the property before closing.
   - Additionally, charges connected with getting a loan: points (discount points, loan origination fees), mortgage insurance premiums, loan assumption fees, costs of a credit report, fees for an appraisal required by a lender, fees for refinancing a mortgage. Generally, points are deducted over the term of the loan.

Special rules may apply to points the buyer and seller pay when the buyer obtains a mortgage to purchase a main home. Under IRS Publication 936, if certain requirements are met, the buyer can deduct the points in full for the year in which they are paid. The buyer must reduce the basis in the home for any seller paid points.

3) Mortgage Assumption: If the buyer buys property and assumes an existing mortgage on the property, buyer's basis includes the amount paid for the property plus the amount to be paid on the mortgage.
4) Constructing Assets: If taxpayer builds property or has it built for them, construction expenses are part of basis which may include the following costs: land, labor and materials, architect's fees, building permit charges, payments to contractors, payments for rental equipment, and inspection fees.

Basis for Capital Gains

Before calculating the gain or loss on sale of real property the seller must make adjustments to the original cost basis of the property which becomes the adjusted basis of the property sold.

For real estate the following costs increase basis: capital improvements which include an addition to the property, replace the roof, pave driveway, install central air conditioning, plumbing, rewire the property. In addition: assessments for local improvements including water connections, sidewalks, roads, casualty losses, legal fees include costs of defending and perfecting title and zoning costs.

Costs deducted as current expenses cannot be added to basis. So if the taxpayer elects to deduct costs they cannot be added to basis. If the taxpayer elects to capitalize costs they are added to basis.

Decreases to basis include: depreciation, casualty or theft loss deductions or insurance reimbursements.

For casualty or theft loss, the basis of property is decreased by any insurance or other reimbursement and by any deductible loss not covered by insurance.

Easements reduce the basis of property. The amount received for granting an easement is generally considered to be a sale of an interest in real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, the basis is reduced in that part to zero and any excess is a recognized gain.

Depreciation decreases the property by the depreciation deducted under the elected method of depreciation as declared under the taxpayer tax returns.

IRS Publication #527 Residential Rental Property

Under IRS Publication #527 Residential Rental Property (including rental of vacation homes) has specific rules. For residential rental activity, with no use of the dwelling for personal purposes, generally for each year all income is reported and all out of pocket expenses are deducted. Any expenses paid to improve the rental property must be capitalized. An expense is an improvement if it results in a “betterment to the property”, restores the property, or adapts the property to a new or different use.

Capitalized costs include the following:

1) Betterments: Expenses that may result in a betterment to the property includes expenses for fixing a pre-existing defect or condition, enlarging or expanding the property, increasing the capacity, strength, or quality of the property;
2) Restoration: Expenses that may be for restoration include: expenses for replacing a substantial structural part of the property, repairing damage to the property after a casualty loss or rebuilding the property to a like-new condition;

3) Adaptation: Expenses that may be for adaptation include expenses for altering the property to a use that is not consistent with the intended ordinary use of the property when the property was first rented.

IRS Publication #527 lists extensive examples of improvements which are subject to capitalization, including:

- Additions: bedroom, bathroom, deck, garage, porch, patio;
- Lawn & Grounds: landscaping, driveway, walkway, fence, retaining wall, sprinkler system, and swimming pool
- Misc.: storm windows, doors, new roof, central vacuum, wiring upgrades, satellite dish, security system
- Heating & A/C: heating system, central A/C, furnace, ductwork, central humidifier, and filtration system
- Plumbing: septic system, water heater, soft water system, filtration system
- Interior Improvements: built-in appliances, kitchen modernization, flooring, wall-to-wall carpeting
- Insulation: attic, walls, floor, pipes, duct work.

Unless capitalized, the following rental expenses may be deducted: advertising, auto and travel expenses, cleaning and maintenance, commissions, depreciation, insurance, interest, legal/prof fees, local transportation expenses, management fees, mortgage interest paid to banks, points, rental payments, repairs, taxes and utilities.

Depreciation is a capital expense used to recover cost in an income producing property taken over the expected life of the property. Rental property may be depreciated when it is ready and available for rent.

Depreciation of Rental Property

Income producing rental property cost is recovered through yearly tax deductions. The property cost is recovered by deducting some of the cost each year on taxpayer’s tax return i.e. depreciation.

Three factors determine how much depreciation can be deducted each year:

1) Taxpayer’s basis in the property
2) The recovery period for the property
3) The depreciation method used.

Depreciation can only be deducted for that part of the property used for rental purposes. Depreciation reduces your basis for figuring gain or loss on a later sale or exchange.

Property can be depreciated if it meets all of the following requirements:

1) Taxpayer owns the property
2) Taxpayer uses the property for income producing activity (e.g. rental property) or the property is used in taxpayer’s business.

3) The property has a determinable useful life
4) The property is expected to last more than one year.

Rental property that cannot be depreciated includes land and certain excepted property.

Land cannot be depreciated because land does not generally wear out, become obsolete or get used up. Taxpayer cannot depreciate property placed in service and disposed of in the same year or equipment used to build capital improvements.

Rental Property is depreciated when first placed in service for the production of income. Depreciation ceases when the cost is fully recovered or when it is retired from service whichever happens first.

Rental Property Depreciation Methods

Taxpayers generally must use the Modified Accelerated Cost Recovery System (MACRS) to depreciate residential rental property placed in service after 1986. For rental property placed in service before 1987, depreciation is calculated under one of two of the following depreciation methods:

Accelerated Cost Recovery System (ACRS) for property placed in service after 1980 but before 1987 or straight Line or declining balance method over the useful life of the property placed in service before 1981.

For rental property placed in service before 1981 Taxpayers use the same method of figuring depreciation that they used in the past. For real property acquired for personal use before 1987 and changed to business or income producing use after 1986 the MACRS system is used, which includes a residence changed to rental use.

For improvements made after 1986, to property placed in service before 1987, as separate depreciable property, the property is depreciated under MACRS, if it is the type of property that otherwise qualifies for MACRS depreciation.

The basis of property used in a rental activity is generally its adjusted basis when you place it in service in that activity which adjusted basis is its cost (or other basis when acquired) adjusted for certain items occurring before it was placed in service in the rental activity. Property depreciated under MACRS may also have to reduce its basis by certain deductions and credits with respect to the property.

COST BASIS

The basis of property purchased is its cost which is the amount paid in cash, in debt obligation, in other property, or in services and sales tax charged on the purchase, freight charges to obtain the property, and installation and testing charges.

If Taxpayer deducted state and local general sales taxes as an itemized deduction on Schedule A (Form 1040) the sales taxes are not part of the cost basis (such taxes were deductible before 1987 and after 2003).

For loans with low or no interest which are used to purchase property, the basis of the property is the stated purchase price, less the amount considered to be unstated interest.

The purchase of real property such as a building and land, certain fees and other expenses paid are part of the cost basis in the property.

Real estate taxes owed by the seller, and paid by the buyer, which are not reimbursed by the seller, are added to the basis in the property

Settlement fees and costs for purchase of the property are part of the basis in the property including: abstract fees, charges for installing utility services, legal fees, recording fees, surveys, transfer taxes, title insurance, any amounts that seller owes that buyer agrees to pay such as back taxes, interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

The following settlement fees and costs cannot be included in basis in the property: fire insurance premiums, rent or other charges relating to occupancy of the property before closing, charges for a loan including: points (discount points, loan origination fees), mortgage insurance premiums, loan assumption fees, cost of a credit report, fees for an appraisal required by a lender.

For mortgage assumptions, if you buy a property and become liable for an existing mortgage on the property, the basis in the property is the amount paid for the property plus the amount remaining to be paid on the mortgage.

For purchase of real estate, the cost between the land and the buildings must be divided and allocated to calculate the basis for depreciation of the building. The part of the cost allocated to each asset is the ratio of the fair market value of that asset to the fair market value of the whole property at the time purchased. If it is not certain of the fair market value of the land/building taxpayer may divide the cost between them based on their assessed values for real estate tax purposes.

For basis other than cost, taxpayer cannot use cost as a basis for property received: in exchange for performance of services, in exchange for other property, as a gift, from your spouse or former spouse as a result of a divorce, or as an inheritance.

ADJUSTED BASIS

To calculate the property's basis for depreciation, Taxpayer must make certain adjustments (increases or decreases) to the basis of the property for events occurring between the time the property was acquired and the time it was placed in service for business or production of income.

Increases to basis include the cost of all items properly added to a capital account. These costs include: the cost of any additions or improvements made before placing property service as a rental that have a useful life of more than one year, amounts spent after a casualty to restore the damaged property, the cost of extending utility service lines to the property, legal fees such as the cost of defending and perfecting title, or settling zoning issues.

ADDITIONS OR IMPROVEMENTS

Additions to basis include the amount of an addition or improvement actually cost including any amount borrowed to make to make the addition or improvement. These costs include: all direct costs, such as labor or materials, but does not include Taxpayer’s own labor.

Assessments for items which increase the value of the property, such as streets and sidewalks must be added to the basis of the property.

DEDUCTING OR CAPITALIZING COSTS

Basis does not include costs deductible as current expenses. Certain costs may be either deducted or capitalized. If you capitalize these costs they are added to basis. If deducted these costs, are not included in basis.

The costs Taxpayer may choose to deduct include carrying charges such as interest and taxes that must be paid to own the property.

Taxpayer must decrease the basis for certain costs which include: insurance or other payments received as a casualty or theft loss, casualty loss not covered by insurance for which a deduction is taken, amounts received for granting an easement.

MACRS DEPRECIATION

Most business and investment property placed in service after 1986 is depreciated using MACRS which includes two systems that determine how you depreciate the property: General Depreciation System (GDS) and the Alternative Depreciation System (ADS). Taxpayer must use the GDS unless required by law to use ADS or Taxpayer elects to use ADS.

Under MACRS, each item of property that can be depreciated is assigned to a property class, determined by its class life which determines the depreciation method and recovery period. Under MACRS, property placed in service during 2016 includes residential rental property that includes any real property that is a rental building or structure for which 80% or more of the gross rental income for the tax year is from dwelling units.

The general depreciation system for roads, shrubbery, and fences is 15 years (GDS) and 20 years (ADS). Residential rental property (buildings and structures) and structural components such as furnaces, water pipes, venting) is 27.5 years (GDS) and 40 years (ADS).

Additions and improvements such as a new roof have the same recovery period as that of the property to which the addition or improvement is made, determined as if the property were placed in service at the same time as the addition or improvement.