

ARE YOU A REAL ESTATE INVESTOR
OR DEALER IN REAL ESTATE?

WILL THE IRS AGREE WITH YOUR ANSWER?

DOES THE ANSWER REALLY MATTER?

WOULD THE USE OF A LAND TRUST
HELP ME SAVE INCOME TAXES?

WHAT IF I USE MY IRA OR ROTH
FOR FLIPS AND SHORT SALES?

I just left a networking meeting that was filled with real estate “investors.” They are busy doing Flips, short sales, partial interest deals and other very creative transactions. Most of the people there consider themselves to be an Investor, but the IRS will likely consider most of them to be a Dealer.

Even though you may only do a few deals a year, the IRS will very likely attempt to classify you as a Dealer and the difference in taxes can be very substantial. The time to do the planning to reduce your income tax costs is before the year ends. In fact, the earlier in the year that you start, the better the results will be. Most people attempt to do their tax planning after the year ends, and many after the IRS has called them in – but the wise person will sit with a qualified professional and learn what to do – during the year – to minimize their taxes – and then what they learned from their advisor.

It is surprising that so many people who are engaged in the business of real estate, whether as an investor, as a dealer, or as a broker or agent, no little or nothing about land trusts. Land trusts are the most powerful tool the investor or dealer may have, and when its operation and use is understood, it is the absolute best way to channel profits into your self-directed retirement accounts. If you can channel your real estate profits into a Roth IRA, those profits will never be taxed, if you keep the rules, of course. If you channel the profits into a traditional IRA or other retirement account, the profits will be deferred, for tax purposes, until you make withdrawals – so you will be able to use the money that you would have paid in taxes to make more money.

Read through this short paper and then contact us. This short document will not answer all of the questions that should come to your mind when reading it, but it will help you begin the thinking process of how to keep more of the money you earn. When you are ready to reduce your taxes and protect your assets, give us a call and we will help you keep more of what you earn.

Are you a Real Estate Investor or a Dealer?
Will the IRS agree with you?

Qualifying as an Investor can save thousands of dollars in taxes every year for most people, but not everyone. In some cases, you may pay less in taxes as a Dealer than as an Investor, but most people will pay significantly more in taxes over the long term if classified as a Dealer. You cannot switch back and forth from year to year.

The most important factors in determining whether you are a Dealer or an Investor are:

- Your purpose for acquiring, holding and selling property – did you purchase and hold the property for sale or investment?
- The number, frequency and continuity of sales of real estate.
- How long you held the properties sold.
- Who sold the property, a broker or you?
- What you did to improve the property after you bought it?
- How the majority of your income is earned.
- What you spend the majority of your working hours doing—what business.
- How many properties you owned during the year and how long you owned them.
- The amount and type of marketing you did.
- Do you have a real estate sales office or staff?

The more frequent the sales, the more time and effort spent on sales, and the shorter the time period the property is held, the more likely that IRS will seek to classify you as a Dealer and the more likely that you will pay more in total taxes.

Remember, the burden of proof is on you, so you must have the required records and support.

Does it really matter how I am classified by IRS?

If you are classified as a *Dealer*, then your profits will be ordinary income earned in a trade or business and your losses will not be limited by the passive loss rules. Being classified as a Dealer means no special rates or benefits on the profits from your sales.

You will pay self-employment taxes on your earnings, you will not qualify for 1031 treatment on exchanges, you will not be able to use the installment sales method of deferring profits, and you will not qualify for long or short-term capital gains treatment on the sale of properties, even if you held the property more than one year.

The good news is that as a Dealer, you will be able to deduct all of your interest and other expenses on the property in the year you pay it, even if there are large losses.

If you qualify as an *Investor*, your profits will be treated as long or short term capital gains so that there will be no self-employment taxes on this income. Plus, long-term gains get special tax rates. Investors qualify to use the 1031 tax deferral rules and may use the installment sales rules for qualifying sales.

As an Investor, you may only deduct interest on your investment properties (those not sold) to the extent that you have investment income and will have limitations on the deductibility of other expenses for property not sold. There may be other limitations, as well, based on income and there may be AMT complications. (Expenses not allowed are carried forward until the property is sold, however, so the deduction is not lost.)

Can I be both an Investor and a Dealer?

The answer is yes, but you should hold your Investor properties in a different entity than the one that holds your Dealer properties.

No properties should ever be in your personal name, except perhaps your homestead. Put those properties that will qualify for Investor status in one entity and do the flips and short sales through a different entity, use different bank accounts, file a tax return for each entity, and make the proper elections in a timely filed return.

Would the use of a Land Trust help?

The use of a Land Trust could help make the case that you were an Investor. However, if you found the deal, found the buyer, were the Trustee, managed the repairs, negotiated with the bank, the seller, the buyer, then a Land Trust may not help. See our web page on Land Trusts.

We recommend that you work with a partner and an independent third party trustee. The partner hires any brokers, repair people, etc., to support your claim of being a passive investor.

What if I use my IRA or Roth?

You may use your IRA or Roth for real estate transactions, but not as a Dealer. You must be able to qualify as an Investor. Using a Land Trust will help support your case, but if you act as a Dealer and use your IRA, you could trigger recognition of your entire account in one year and also pay a 10% penalty. We recommend that you make sure that you have an experienced CPA or Attorney to guide you.

If you use your IRA, including self-directed 401K or other retirement accounts, incomes taxes are deferred until you begin to draw money out of the account later on in life.

If you use a Roth, then the profits in your Roth are never taxed, if you keep the rules, of course. This means that your real estate profits could be tax-free when you earn them and tax-free when you pay them to yourself.

You may self-direct IRAs, 401Ks, Roths, 527 Plans, SEP IRAs, Defined Benefit Plans, 403Bs and Simple IRAs.

The two illustrations that follow were created to show the tax difference, in a good year, between Dealer status and Investor status. These illustrations that follow are obviously not complete returns. There are intended to show the impact of the items illustrated only. Other factors not illustrated may produce a different result.

DEALER STATUS ILLUSTRATION

Description	Amount
Like-Kind Exchange profits (1031 not allowed for Dealer)	\$100,000
Flip and Short Sale Profits from Land Trusts, LLCs, Sub-S, etc	100,000
Interest on Property not sold	-25,000
Taxable income	<u>\$175,000</u>
Self-Employment Tax	\$16,368
Income Tax	<u>31,380</u>
Total Tax	<u>\$47,748</u>

Dealers do not qualify for 1031 treatment, so all of the profits must be treated as ordinary income subject to regular rates. Dealers do not qualify for installment sales treatment.

Flips, short sale profits, and other income from real estate will be treated as ordinary income, even if it came through an LLC or Sub-S. It is true that many people attempt to avoid self-employment tax through using a Sub-S or LLC, but IRS is very focused on that issue.

Interest on property not sold during the year is an ordinary business expense and not subject to passive loss limits or other limitations. Other expenses on property not sold will also be treated as an ordinary business expense during the year it was paid.

INVESTOR STATUS ILLUSTRATION

Description	Amount
Like-Kind Exchange profits (1031 deferred for Investor)	\$Deferred
Flip and Short Sale Profits from Land Trusts, LLCs, Sub-S, etc	100,000
Interest on Property not sold	Deferred
Taxable income	<u>\$100,000</u>
Self-Employment Tax	\$-0-
Income Tax	<u>13,896</u>
Total Tax	<u>\$13,896</u>

Investors may elect (or not elect) 1031 treatment on qualifying sales. If elected, the profit is deferred until the new property is sold.

Flips, short sale profits and profits from other real estate sales will be treated as short or long-term capital gains depending on how long the property was held. Long-term capital gains are taxed at a maximum of 15% and neither long nor short term gains are subject to self-employment taxes.

Interest on investment property not sold during the year is deductible only to the extent that you have investment income (for example, interest or dividends) and there are limitations on the deduction of other items. Deductions not allowed are carried forward until the property is sold, so they are not lost.