

Investment Questions...

Answered

Q. Is my rental home an investment property?

A. Yes, if it is used in a trade or business or for investment. A home or condominium rental considered “investment property”.

Q. Would I need to invest in another rental home or condominium?

A. You could do that if you wished but you are not limited to another home or Condo. Another type of investment real estate would serve the purpose, such as an office building, shopping center, warehouse or even undeveloped land held for investment.

Q. What if I wanted to invest in something other than real estate?

A. Other property held primarily for sale such as business inventory, stocks, bonds, mutual funds and partnership interests will not qualify.

Q. What about a leasehold?

A. A leasehold interest of at least 30 years may be exchanged for a fee, simple interest or vice versa.

Q. What if I used my vacation home solely for personal use, can that qualify?

A. Yes and No. Prior to 1997 you could convert the home from personal use to rental, use and hold it for a significant period of time and probably make it work. Whether a legitimate conversion occurred is based on the facts and circumstances. The tax act of 1997 required an owner to occupy the residence for 2 of the past 5 years and then the gain from the sale cannot exceed \$250,000 for single taxpayers (\$500,000 filing jointly) and you are limited to sale once every 2 years. If a couple owns a winter residence and they lived there for 6 months annually and because they meet the “main home” ownership and occupancy test of the new internal revenue code 121 – having lived there for an aggregate of at least 24 months over the last five years, the sale is tax free up to \$500,000 of sale profits. Smart owners of vacation or second homes keep careful records to prove that they meet “main home” occupancy standards with utility bills, voter & automobile registration, business & retirement income and other indicators of primary residence.

Q. Can I build or purchase a new structure or building?

A. Yes. You may purchase a newly constructed property with the exchange proceeds. However, if you already own the property and are building a new structure on it, it probably will not qualify. This is a very technical area and you should consult your tax advisor.

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Q. How much of the taxable gain is excluded from tax?

A. As long as you invest the gain realized in a replacement property equal or more in value to the gross sales price of the old property. If you sold a property for \$200,000 then you would have to spend at least \$200,000 in the new property. If you spend less, then all or at least part of your gain will need to be reported.

Q. What happens to the gain?

A. It will reduce the tax basis of your new replacement property and will be deferred until you sell it. Then you can do a tax free exchange on the newly acquired property when you sell it and do the same to the next, etc.

Q. How does the reduction of tax basis of my replacement property really work?

A. You are selling a property for \$200,000 in which you have a tax basis of \$150,000. This gives you a gain of \$50,000. If your replacement property \$235,000, this gives you a tax basis of \$185,000.

Sales Price of Old Property \$200,000

Tax Basis of Old Property \$150,000

Gain to be Deferred \$50,000

Cost of New Property \$235,000

Less Gain Deferred \$50,000

Tax Basis of New Property \$185,000

Q. If there is no gain, do I still report the transaction to the IRS?

A. Yes. Like kind exchanges must be reported to the IRS whether or not any gain is realized.

Q. I am ready to exchange some property. What do I do?

A. The IRS regulations are very precise and you must follow the guidelines. You cannot constructively receive the proceeds of the property you are selling. The most common way is to find a qualified escrow agent, trustee or intermediary.

Q. What will they do for me?

A. They will actually hold the proceeds in their interest bearing account until you can purchase the replacement property. You will need to enter into a written agreement with the intermediary, which will spell out the legal agreement in detail. Your attorney can prepare the agreement and it is commonly paid for as part of the closing costs of the replacement property. Be sure that the attorney preparing the agreement is versed regarding the tax exchanges because this agreement will make the transaction qualify as a “tax deferred exchange”.

Q. Can anyone be my intermediary?

A. No. Disqualified intermediaries, meaning people that cannot act in that capacity, would include persons who were your employees, attorney, accountant, investment banker, real estate broker or agent during the two year period preceding the sale. They also cannot be you, your agent or relatives.

Q. Can I buy the new property before I sell the old property?

A. No. However, with proper planning and the use of intermediaries, leases or options, this type of transaction may be converted to a qualified like kind exchange. Remember that if you have access to or received cash, this is called constructive receipt or proceeds and the exchange will be invalid

Q. How do I go about purchasing the replacement property?

A. You must identify your property within 45 days of close on the sale of your old property. Remember that the proceeds are being held by your intermediary. There are 3 ways you can use to identify the new property.

1. You may identify up to 3 replacement properties of any value in writing to your intermediary of which you can purchase one or all of the 3.
2. If you name more than 3 properties their total value must not exceed 200% of the value of the old property.
3. You may also identify an unlimited number of properties of any value as long as you acquire 95% of them as replacement property.

Q. How long do I have to close on the replacement property?

A. You must close on the replacement property on or before the earlier of: 1. 180 days after the sale of the replacement property. 2. The due date including extensions of your tax return for the year of transfer.

Q. Do I really need all of this legal paperwork?

A. Yes. If you want the transaction to withstand an IRS audit. It is critical that the correct language be incorporated in all sale contracts. The language in the agreement with the intermediary is also extremely important.

Q. What else should I know?

A. Get your accountant and / or attorney involved early. Tell your real estate agent what you intend to do and how you want to structure the sale of the old property and the purchase of the new property. The buyer of the old property has no involvement in the exchange but must agree to sign any pertinent documents at closing to allow you to accomplish your goal. If properly structured, this is an excellent tool to create wealth and build estates. Please don't cut corners on the professionals that you use and listen to their advice.

TAX INFORMATION FOR REAL ESTATE OWNERS



Q. What about transient & short-term rental?

A. Transient rentals are for less than 30 days and must be licensed by the state of FL. Short term rentals are for less than 6 months. Both must charge State Sales & County Bed Tax.

Q. What about long-term rental properties/

A. Long-term rentals are for periods greater than 6 months. Sales & Bed Tax are not collected.

Q. What could I deduct as an expense, assuming I rent my property on an annual basis?

A. You can generally deduct any expense necessary to produce income. This would include but not be limited to: Management Fees, Insurance, Real Estate Property Taxes, Maintenance Expenses, Homeowner Dues, and Interest on Mortgage Payment and Depreciation.

Q. What do you mean by depreciation?

A. You are allowed an annual deduction on the following estimated life guidelines using the purchase price of your rental property. There are 3 components considered: Land, Equipment (Furnishings etc.) and the structure.

Land: Not depreciable

Equipment: 7 years

Building: 27.5 years

For example: A \$150,000 condo would have this annual depreciation.

Type Value Depreciation

Land (10%) \$15,000 0

Equip. \$12,000 \$1,714

Bldg. \$123,000 \$4,473

Total \$150,000 \$6,187



Q. How would I calculate my gain or loss on a \$150,000 property that I rent full time?

A. We need to make some assumptions:

1. Rental income is \$1,200 per month.

2. You have the following expenses:

A. Insurance \$800

B. Prop. Taxes \$2,250

C. Maint. \$1,000

D. Misc. \$500

3. You have placed the following financing on the property:

A. Amount Down - 20% \$30,000

B. Amount Finan. - 80% \$120,000

C. Amortization 30 Years

D. Interest Rate 7%

E. Monthly Payment \$798

F. Month. Interest (1st yr.) \$700

4. Your monthly cash flow before taxes would be:

Rent Income (12x\$1,200) \$14,000

Less Costs & Expenses

A. Insurance \$800

B. Property Taxes \$2,250

C. Maintenance \$1,000

D. Miscellaneous \$500

E. Loan Payment (12x\$798) \$9,576

Total \$14,126

Income (Positive \$ Flow) \$274

Q. What can I deduct on my tax return?

A. You can deduct only the interest portion of your debt service (mortgage payment), but in addition to your other deductions, you can also deduct depreciation. Your deduction would be calculated as follows:

Rent (12x\$1,200) \$14,000

Less: Costs & Expenses

A. Insurance \$800

B. Prop Taxes \$2,250

C. Maint. \$1,000

D. Misc. \$500

E. Interest (12x\$700) \$700

F. Depreciation \$6,187

Total \$19,437

Tax Loss Deduction (\$5,037)

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Q. What kind of savings would this mean to me tax wise?

A. Assuming a 30% tax bracket, it could save 30% of \$5,037 or \$1,511 in taxes. Therefore, you can actually own this unit without investing any additional cash and it would mean that you would have a positive cash flow of \$1,785.

Q. Does the IRS limit the amount of deductions?

A. Yes, if your adjusted income is greater than \$100,000 then the loss is phased out based on 50 cents for every dollar that your gross income exceeds \$100,000. Therefore using the example above, the deduction would be phased out when adjusted income exceeds \$110,074. $\$100,000 + (\$5,037 \times 2)$.

Q. If my adjusted income is less than \$100,000, is there a limit to my deduction?

A. You can deduct up to \$25,000 in rental losses per year as long as you actively participate in the management of your rental property. In the example above, the \$5,037 rental loss would be fully deductible.

Q. What does actively participate mean?

A. It means that you participate in such activities as setting rent rates, approving maintenance expenses and approving tenants.

Q. If I have a management contract with a property manager, would I be considered as actively participating in the management?

A. Yes, so long as the contract that you have with the property management allows you to have approval for the activities above.

Q. Is the \$25,000 allowed for each rental property?

A. It is the total combined amount of all of your rental properties.

Q. What happens to the losses if they exceed \$25,000 and I am not allowed to take any more this year?

A. You may carry them forward and use them to offset future rental income.

Q. Can I sell my rental unit before I am able to use all the losses?

A. You can deduct any unused accumulated losses in full the year you sell the property.



Q. Are there any Real Estate property taxes required on the rental property?

A. When the property is personal or rental, the real estate taxes are payable to the county the property is located in and also to any incorporated municipality if the property is located within it as well. For example, if the property is located in the City of Fernandina Beach, then the real estate taxes would be payable to Nassau County & the City of Fernandina Beach.

Q. Are there any business licenses that would be needed?

A. You need to check with the municipality where the property is located. Requirement and amounts change from time to time.



INVE\$TOR\$ - WHY WAIT TO MAKE MONEY?

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