

# SOUND ACCOUNTING LEADS TO A MORE PROFITABLE REAL ESTATE COMPANY.



*Profitability in 2019 and Beyond*

HELPING YOU  
INCREASE THE BOTTOM LINE.

In this booklet we cover a few tax-related topics, you as an agent can use, along with tips you can pass along to home buyers and sellers. We've also included some checklists and examples that are relevant to your industry.

# Profitability in 2019 and Beyond

Sound accounting leads to a more profitable real estate company.

## Introduction

As a real estate professional, you know all too well how complicated it is to know all the things your home buyers and sellers might ask you.

In this booklet we cover a few tax-related topics, you as an agent can use, along with tips you can pass along to home buyers and sellers. We've also included some checklists and examples that are relevant to your industry.

If you have any questions about the content, give us a call. We're here to help *Move Your Company Forward* while helping you to increase your bottom line.

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## IS YOUR COMPANY FACING A CASH FLOW CRUNCH?

Cash flow is always an important element in the smooth and successful operation of your business and is particularly key in meeting opportunities and demands.

Generating sales and managing operations are, of course, also important, but ensuring that that cash from those sales is collected and that your company's daily cash flow needs are managed efficiently and effectively is even more important. This is particularly true when the economy goes into a slump. Your business's resources can be stretched to the max and you may find yourself scrambling to keep up with your own accounts payable, let alone worrying about your receivables.

So proper planning is paramount to be able to better avoid a serious cash crunch in the future.

As one step in that planning, it's wise to diagnose your company's cash flow health and ferret out any weaknesses that could create problems down the line. Here is a checklist to help you get a picture of just how healthy your cash flow is.

Financial Health Checklist	YES	NO
Turnaround time is within our norms.		
Bills are generated immediately.		
Bills are accurate, complete and understandable.		
We finance equipment without taking cash from operations.		
Prices compensate for time spent on jobs and associated risks.		
Work is consistently completed efficiently and on time.		
Budgets are detailed and closely monitored.		
We determine the financial viability of outsourcing work.		
We adequately control employee overtime.		
We negotiate the best price and terms for materials and supplies.		
We forecast monthly cash flow and make financial arrangements.		
Our banker is aware of business and financial needs.		
Staff compensation is linked to productivity and profits.		
Standard operating procedures are written and uniformly followed.		
Labor, technology and equipment productivity are measured and we use the data in decision-making.		
Our bidding process for new work is accurate.		
Our accounting and technology systems provide the data we need to make timely and effective decisions.		

If you answer "no" to any of the above questions, you may have profit and cash flow leaks in your company. Take steps to plug the holes before you face significant financial damage.



Photo: Geralt

## STRETCH OUT REAL ESTATE TAX BENEFITS

Let's say you own a C corporation that needs to raise some cash and you're considering the sale of a warehouse that has been depreciated to zero. But, the company still uses the warehouse and doesn't want to lose control of it.

Think about entering into a sale-lease transaction. You buy the warehouse personally and then lease it back to the company.

### Advantages

Your company raises the cash it needs and retains control of the warehouse. In addition, the lease payments are deductible by your company so they generate tax benefits from a property that was no longer providing depreciation deductions. Meanwhile, you get a source of income and can start a new depreciation schedule based on what you paid for the warehouse. The deductions provide a tax shelter for some of your lease income.

This plan may hold particular appeal to you if you are close to retirement because you can get a regular income without giving up equity in the company. When you're no longer active in the business, the payments will become "passive" income, which could be offset by passive losses from tax-shelter investments. If you eventually sell the property, you'll probably owe tax of 25% on depreciation you've taken and a maximum of 15% on long-term capital gains from appreciation.

But if your corporation continued to own the warehouse, subsequent appreciation probably would have been taxed at 34%. What's more, any future gains go to you, not to the company, so you can collect cash without having to take a nondeductible dividend from the company.

In order for this deal to work, the property's useful life must exceed the lease term. All the terms of the transaction — sale price, lease rates, renewal rates, repurchase option — must be at fair market value.

### The Bottom Line

You must assume the risk of losing money and have a real chance of making money, in order for the tax benefits to be sustained. As with all complex transactions, consult with us to help you structure the deal.

## TAX IMPLICATIONS OF REPOSSESSING A FORMER PRINCIPAL RESIDENCE

Let's say you sold your principal residence for a healthy profit a few years ago and took back an installment note from the buyer to cover part of the sale price. This is called a seller-financed installment sale, and they were fairly common in hot markets a few years ago.

Unfortunately, not all seller-financed transactions work out. If a deal falls through, what are the tax implications if you repossess the property and then resell it? Good question. The financial results might be favorable and the tax implications might be favorable too. On the other hand, the tax results may not be great, depending on your specific circumstances.

### Payments Received Before Repossession

When you sold your former principal residence the first time, you probably collected a down payment and some interest payments on the installment note before the buyer bailed. Depending on the terms of the deal, you also might have collected some principal payments. If you sold the home for a profit, the gross profit percentage multiplied by the down payment and any principal payments count as potentially taxable gains. The gross profit percentage equals the total gain divided by the total sale price.

You were probably eligible to exclude (pay no federal income tax on) any such gains, thanks to the principal residence gain exclusion (see the right-hand box for the qualification rules). It allows qualified sellers to exclude some or all of the profits received from federal income tax.

In any event, you must report any interest received on the installment note as ordinary income taxed at your regular rate.

So far so good, but now you've repossessed the property and face new tax implications.

The general rule for real estate repossessions (from Section 1038 of the Internal Revenue Code) states that repossessing a property triggers taxable capital gain equal to the amount of cash you receive from the buyer's down payment and/or principal payments before the repossession. As mentioned earlier, any interest collected on the installment note is ordinary income taxed at your regular rate (as opposed to lower-taxed capital gain).

### Gain Exclusion Exception

#### Federal Home Sale Gain Exclusion Rules

A favorable exception to the general rule allows you to use the principal residence gain exclusion break to shelter gain on both the repossession and the resale as long as:

The original sale qualified for the gain exclusion and you resell the property within one year after repossession.

If you pass these tests, you're allowed to treat the original sale and the subsequent resale as a single transaction that took place on the original sale date.

Here's how that could work to your tax-saving advantage.

### Federal Home Sale Gain Exclusion Rules

An unmarried seller can exclude (pay no federal income tax on) up to \$250,000 of gain (\$500,000 for married joint-filing couple). To qualify, you must pass the following tests.

**Ownership Test:** You must have owned the property for at least two years during the five-year period ending on the sale date.

**Use Test:** You must have used the property as a principal residence for at least two years during the same five-year period. (Ownership and use periods need not overlap.)

**Larger \$500,000 Exclusion Test:** To be eligible for the maximum \$500,000 joint-filer exclusion, at least one spouse must pass the ownership test, and both spouses must pass the use test.

**Previous Sale Test:** If you excluded gain from an earlier principal residence sale, you generally must wait at least two years before taking advantage of the exclusion deal again. If you're a married joint filer, the larger \$500,000 exclusion is only available if neither you nor your spouse claimed an exclusion for an earlier sale within two years of the later sale.

**Prorated Exclusion:** If you don't qualify for the maximum \$250,000/\$500,000 gain exclusion due to failure to meet the timing rules, you may qualify for a prorated exclusion amount. For instance, if you're a single individual and used a property as your principal residence for only one year during the five-year period ending on the sale date, you qualify for a prorated exclusion of \$125,000.



Photo: Fotografie Link

### **Example 1: Gain Exclusion Break Is Available**

You're a married joint-filer. On February 1, 2008, you sold your principal residence for \$600,000. The sales proceeds consisted of a \$50,000 cash down payment and a \$550,000 installment note payable to you. The note called for monthly interest-only payments until the note came due on January 1, 2013. At that time, the entire \$550,000 principal balance was to be repaid. So, this was a seller-financed installment sale with a balloon payment at the end.

Your sales costs were \$25,000 and the property's tax basis was \$175,000. Based on the assumption that the buyer would make the \$550,000 balloon payment as scheduled, you had an installment sale gross profit percentage of 66.667 percent (\$400,000 profit divided by \$600,000 sale price).

Assume the sale qualified for the \$500,000 joint-filer gain exclusion because you and your spouse owned and used the property as your principal residence for years. The \$400,000 profit would have been entirely federal-income-tax-free, and you did not have to report any taxable gain from the \$50,000 down payment on your 2008 tax return or any taxable gain in 2013 if the balloon payment had been made as scheduled.

Unfortunately, the buyer made the interest-only payments for four years and a few months and then bailed. On September 1, 2012, you repossessed the property after incurring \$15,000 in legal fees and other costs to do so.

Thanks to a resurgent real estate market, you were then able to resell the property on February 1, 2013 for \$555,000 in a conventional sale. Assume you incurred \$35,000 of selling costs on the resale.

Because the original sale qualified for the gain exclusion break and because the resale occurred within one year of the repossession date, you're allowed to treat the two sales as one transaction that took place on the original sale date. Therefore, your gross sales proceeds are \$605,000 (\$50,000 down payment from the original sale plus \$555,000 resale price). Your total selling costs are \$60,000 (\$25,000 from the original sale plus \$35,000 from the resale). Your updated tax basis in the property is \$190,000 (the

original \$175,000 plus \$15,000 of repossession costs). The gain on sale is \$355,000 (\$605,000 gross sales proceeds minus \$60,000 selling costs minus \$190,000 basis). The \$355,000 gain is federal-income-tax-free because it's sheltered by your \$500,000 joint-filer gain exclusion. Therefore, you do not need to report taxable gain from the resale on your federal tax return.

All in all, these financial and tax results are pretty good.

### **What If You Don't Resell Fast Enough?**

If you fail to resell the property within a year of the repossession date, the original sale, the repossession and the resale are treated as three separate transactions, which will sometimes (but not always) lead to less-favorable tax results.

Assuming the original sale qualified for the gain exclusion, the down payment and any principal payments received before the repossession are usually fully sheltered by your exclusion.

If you have gains on the separate repossession and resale transactions, the gain exclusion is only available to the extent you meet the timing rules as of the repossession and resale dates.

However, this is not as bad as it sounds, because the gain exclusion from the original sale reduces your gross profit and gross profit percentage, which effectively reduces or eliminates any later repossession gain or resale gain.

Examples 2 and 3 below illustrate how the reduced gross profit rule can work to your tax-saving advantage in a resale. The numbers in Examples 2 and 3 are based on following Worksheets A, D, and E in IRS Publication 537, Installment Sales. The tax code and related regulations provide no specific guidance on the scenarios presented in Examples 2 and 3, so Publication 537 is basically the last word in such situations.

### **Example 2: Tax-Free Gain from Resale More than One Year after Repossession**

Same basic facts as Example 1, except this time assume the resale date is October 1, 2013, which is more than one year after the repossession date.



Photo: Image 4 You

Therefore, the favorable exception explained in Example 1 is unavailable. As a result, the original sale, the repossession, and the resale are treated as three separate transactions for federal income tax purposes.

The tax results from the original 2008 sale are the same as in Example 1 — no taxable gain thanks to the gain exclusion privilege.

The repossession gain, the tax basis of the repossessed property, and the resale gain/loss are calculated as shown below. These calculations are based on a 0 percent gross profit percentage for the original sale, because the gain exclusion privilege made the entire \$400,000 gain on the original sale tax-free.

### Repossession Gain Calculation

1. Down payment received in 2008	\$ 50,000
2. Gain already reported (\$50,000 times 0 percent gross profit percentage)	\$ 0
3. Tentative repossession gain (line 1 minus line 2)	\$ 50,000
4. Gain limitation (\$0 gross profit minus \$0 gain already reported minus \$15,000 repossession costs, but not less than \$0)	\$ 0
5. Taxable repossession gain (lesser of line 3 or line 4)	\$ 0

### Repossession Property Basis Calculation

1. Face value of note on repossession date	\$ 550,000
2. Uncollected gross profit (line 1 times 0 percent gross profit percentage)	\$ 0
3. Adjusted tax basis of note (line 1 minus line 2)	\$ 550,000
4. Taxable repossession gain (from above)	\$ 0
5. Repossession costs	\$ 15,000
6. Basis of repossessed property (line 3 plus line 4 plus line 5)	\$ 565,000

Key Point: In other words, the \$565,000 basis is comprised of the \$175,000 original basis plus \$25,000 original sales costs plus \$400,000 original excluded gain (which still increases your basis) plus \$15,000 repossession costs minus \$50,000 down payment received from the original sale.



## Resale Gain/Loss Calculation

1. Net sales proceeds (\$555,000 minus \$35,000 selling costs)	\$ 520,000
2. Adjusted tax basis of property (from above)	\$ 565,000
3. Non-deductible personal loss (line 1 minus line 2)	\$ 45,000

**Key Point:** The preceding outcome assumes you cannot characterize the loss as from an investment property sale instead of a personal residence. Even if you could, a special rule says your initial adjusted basis in the repossessed property for tax loss purposes cannot exceed its fair market value (FMV) on the date it was converted into an investment property. In this example, if the FMV figure was below \$520,000 on the conversion date (it probably was), you wouldn't have an allowable loss on the resale. (The special basis rule is intended to disallow the loss from a decline in value that occurs before the conversion date. But a further decline in value after the conversion can result in an allowable loss. Don't forget that basis reductions from post-conversion depreciation can offset some or all post-conversion value decline.)

### Example 3: Taxable Gain from Resale More than a Year after Repossession

Same basic facts as Example 2, except this time assume you sold the repossessed property for a whopping \$700,000. You would have a \$100,000 capital gain (\$700,000 minus \$35,000 selling costs minus \$565,000 basis) that could not be sheltered by the gain exclusion privilege, because the home was not used as your principal residence at any time during the five-year period ending on the sale date. Your gain would be long-term gain, because your holding period for the repossessed property would include your ownership period before the ill-fated seller-financed sale and your ownership period after the repossession. The \$100,000 resale gain must be reported on your Form 1040.

**Key Point:** The maximum federal rate on long-term capital gains can be as high as 20 percent, and you might also get hit with the 3.8 percent Medicare surtax on net investment income if your income is high enough.

### Conclusion

Depending on your exact circumstances, the federal income tax results from selling your principal residence in a seller-financed installment sale deal, repossessing the property, and reselling it may be benign (as in Examples 1 and 2) or not (as in Example 3).

When repossession is looming, get your tax adviser involved as soon as possible. Careful advance planning often leads to better tax results.



Photo: Hamonazaryan1

## HOW A DEDUCTIBLE HOME OFFICE AFFECTS A SALE

If you use part of your home as an office and take deductions for related expenses on your annual tax return, can you claim a valuable federal tax break when you sell? Specifically, can you claim the capital gains exclusion of up to \$250,000 for single taxpayers (\$500,000 for married couples filing jointly)? In many cases, you can still take advantage of this tax benefit.

As long as your deductible home office space is in the same dwelling unit as your residence, you can use the gain exclusion to shelter profit from the entire property. In other words, you are not required to split the sale into two separate deals for tax purposes (one transaction for the sale of the residential part of your property and another for the sale of the office part).

However, you will be taxed on gain up to the amount of depreciation deductions on the office part of your property that were claimed after May 6, 1997. You will owe a maximum federal rate of 25% on this profit (called unrecaptured Section 1250 gain).

However, paying tax on this portion of your profit is not really so bad, considering that you collected earlier tax savings from the office part of your property.

### **Separate Dwelling**

The tax outcome is less favorable when the office is not in the same dwelling unit as the residence.

For example, say you claimed home office deductions for what was formerly a carriage house, garage, or finished basement with cooking and bathroom facilities and a separate entrance. In these cases, even though the office is on the same property or in the same building, it is considered to be a separate dwelling unit that is not part of the residential portion of your property. In these scenarios, you must pass the ownership and use tests (see right-hand box) for both the office portion of your property and the residential part in order to treat the sale as a single transaction that is eligible for the gain exclusion.

If you fail the tests for the office part (for example, because it was used as a deductible office for the entire five-year period ending on the sale date), you must calculate separate gains for the office and residential portions of



your property. Then, you can use the gain exclusion only to shelter profit from the residential part. Any gain on the office part is usually fully taxable. You will generally owe a federal income tax rate of no more than 25% on gain up to the amount of post-May 6, 1997 depreciation and no more than 15% on any remaining profit from selling the office part of your property.

Here are a couple of smart strategies if you are thinking about selling property that has also been used as a home office:

**Strategy #1.** When the office space is in a separate dwelling unit, and you think you may sell the whole property before too long, consider not taking home office deductions for at least two years before the anticipated sale date. That way, you are allowed to use the gain exclusion to shelter profit from the entire property (subject to the recapture rule).

**Strategy #2.** Continue claiming home office deductions if your office space is in the same dwelling unit as your residence. Under a strict interpretation of the rules, the IRS says you must recapture allowable post-May 6, 1997 depreciation whether or not you claimed it, so you may as well benefit from the write-offs.

### What Can You Deduct?

If you qualify to take home office deductions, you can deduct a portion of expenses including mortgage interest, depreciation, utilities, insurance, and repairs.

The office must be used regularly and exclusively as your place of business, which means personal activities cannot be conducted there. Here are a few other tips for home office deductions:

- Take photos to prove the room was used for business purposes in case of an IRS audit.
- To figure the percentage of your home used for business, you can use two methods — square footage or the number of rooms.
- If you don't qualify for the deduction, you might be able to get a write-off for the expenses involved in storing business inventory or product samples in a room in your home.
- Home office deductions can't exceed your income. But if they are greater, you can carry the loss forward.
- If a home office is required by an employer, it's a good idea to get a written statement from the company explaining the requirement.



### Gain Exclusion Qualification Rules

If you are single, you can potentially sell your principal residence for a gain of up to \$250,000 without owing anything to the U.S. Treasury. If you are married and file jointly, you can potentially pocket up to \$500,000 without paying federal tax. To qualify, you generally must pass both of these tests:

1. You must have owned the property for at least two years during the five-year period ending on the sale date (referred to as the ownership test).
2. You must have used the property as a principal residence for at least two years during the same five-year period (referred to as the use test).

To be eligible for the \$500,000 joint-filer exclusion, at least one spouse must pass the ownership test, and both spouses must pass the use test.

If you excluded a gain from an earlier principal residence sale under these rules, you generally must wait at least two years before taking advantage again. For joint filers, the exclusion is only available when both spouses have not claimed an exclusion for an earlier sale within two years of the sale date.

Gain beyond what you can exclude under these rules is generally treated as a long-term capital gain taxed at a maximum federal rate of no more than 15%. However, gain caused by depreciation deductions on the part of your home used as a deductible office may be taxed at up to 25%.

Congratulations!  
Now you have the basic steps to *Move Your Company Forward*.

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Do you need a partner to *Move Your Company Forward*?

Call us at 303-792-9445.

## ABOUT LANG ALLAN & COMPANY CPAS PC

Lang Allan & Company CPAs PC provides audit, review and compilation attest services, tax financial accounting and management and consulting services to small- and mid-size real estate companies. Our goal is to serve your needs in a professional, prompt, and courteous manner.

We believe it is important for you to know we care about you and your future. We will always provide personalized services to businesses and their owners.

At Lang Allan & Company CPAs PC we have an expertise in serving the real estate industry throughout the greater Denver area. Through our experiences and understanding of the industry and communications with sureties and bankers, we gain a further understanding of the issues relevant to the real estate industry.

As a client, you will be able to leverage our relationships with other professionals and gain an increased credibility with financial institutions and bonding companies.

Our big-firm experiences, combined with small-firm service helps to *Move Your Company Forward*.

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