Chapter 2

GET THE SCOOP ON...

Types of tax: federal, state, and local (and what happens if you don't plan ahead for them) ▪ Hiring a great accountant/financial advisor ▪ Understanding depreciation ▪ Repairing versus renovating ▪ Deciding between passive and active ownership ▪ Taking advantage of tax incentives and deductions ▪ Finding out about business licenses and permits ▪ Protecting your investment with insurance ▪ Knowing what type of insurance to carry ▪ Reducing risk through preventive maintenance ▪ Reviewing your policies

Taxes, Licenses, and Insurance

Throughout this book, I refer to running your investment properties as a "business." This is the best way to keep everything straight, particularly for meeting local, state, and federal tax obligations and requirements; reporting cash-flow; and paying other bills. If you set your rental property up like a business in the beginning, it will keep you on track as your build on you portfolio of properties.

You have income and expenses that have to be accounted for and tracked, not only for your own benefit but also for your state and federal taxes. You need to calculate your income, less your expenses, to determine whether you have a profit and how much in taxes may be due. (If you have a loss, you should be able to apply it against your income.) Remember that owning investment property provides opportunities and great tax benefits. One of the advantages is your ability to deduct all operating expenses and depreciation from your income while the value of your investment is appreciating over time.

That said, tax laws are much more complicated for a investment property than for a personal residence. The taxation laws are quite different and change often, making it difficult to keep up. For this reason, an important part of owning property is having a great financial planner and a certified public accountant (CPA), both of whom have a great deal of knowledge in real estate.

You want to have a general understanding of the taxes and what is expected, as well as knowledge of different types of insurance available to cover your worst-case scenario. In addition, you need to be sure you're complying with your local government agencies. Some cities or counties require special permits and annual inspections by the city inspector or fire department, for health and safety violations.

In the tax world, there are generally two types of income: ordinary income and capital gains. Ordinary income includes your wages, salaries, bonuses, commissions, dividends, rental income, and interest income. This is taxed at varying rates, depending on your tax bracket. On the other hand, you have to handle the other type of tax, capital gains, delicately, because this is the tax for income that is generated when possessions, including stock and real estate, have been sold for a profit. There are formulas for everything when it comes to ordinary income and capital gains income. You need to be sure you have good records and keep your paperwork organized so that you are ready when you meet with your accountant. I highly recommend you meet with your accountant during the year — don't wait until the year is over and you are there to file your tax return for the previous year. By then, it's too late to make changes, and that could quite possibly cost you money. New tax laws and depreciation schedules change often, and there is no way for you to keep up with everything — nor are you expected to. Take the time to make an appointment for a financial and tax review. Plan ahead and be prepared. Have a tax strategy to help you know when to improve your property and when to sell your investment.

Types of taxes

There are many different types of taxes. There are state and federal taxes, local taxes, in some places, city or county taxes, property taxes, and those lovely business taxes. Consult with your accountant for details, and be sure to check with your city, county, and state to be certain you are complying with all requirements.

State tax

Some states don't have a state tax, which means you're not required to do a state tax return. Check with the state government where your property is located to find out about its taxes. Your accountant may have an office in that state or may have a recommendation of whom to contact to obtain the latest information. Many states have a transfer tax and/or a revenue tax, and that accounts for the bulk of state real estate taxes. When you do your tax return and are in a state that has this type of taxation, your accountant can prepare a form that displays the gross and net revenue generated by your properties and calculate what is due.

Some states impose licensing fees for property owners, like a business license due annually based on the size of your property or the income your properties generate. States may also impose licensing fees for rental property. However, the most common tax comes in the form of an amount based on the income — gross (total), not net (after expenses) — that you've generated.

Federal tax

Federal taxes affect everyone. You are required to file your federal tax return on an annual basis and account for your investment property income and expenses. You may have to pay income tax on net revenue, and that amount may be different from what your friend is paying, based on the structure of your business (see Chapter 1) and the way you have taken possession of your property.

There are many ways to structure the set up of your properties. You can have a corporation, partnership, an LLC, trust, and so on. A good accountant will advise you based on your situation. For example, if your rental property is run as a corporation, your accountant may advise you not to have any income in your account at the end of each year to avoid paying a high rate of corporate tax. (You don't want your corporation to be double-taxed.) You can withdraw the money as income, spend it on improvements to your building, or pay bills. Your accountant knows what is the best for your business.

Property tax

Property tax is usually an *ad valorem* (imposed at a percentage of the value) that an owner of real estate or other property pays on the value of the property. Some state tax is based on the size and use of the land. The taxing authority performs or requires an appraisal of the value of the property, and the tax is assessed in proportion to that value.

A major segment of local and governmental agencies receive a large portion of their operating funds by taxing real estate

Watch Out!

If you feel the tax agencies have overvalued your property, contact your tax assessor to find out whether you can have your property reassessed. Remember, though, that the market does change, so don't ask for a reevaluation if there's any indication that your property has *increased* in value.

within their jurisdiction. In many circumstances, the property tax increases quite frequently through several special assessment charges based on improvements, voted-in measures, schools, or emergency services. These charges can be a percentage or a flat rate, depending on how it was voted in by the people or governmental agency.

A professional appraiser usually assesses the property at the time you purchase the property. This is to determine the value based on the property and other comparable properties in the area. There are three basic methods of determining the fair-market value of a property: the sales comparison, the cost approach, and the income approach. Both appraisers and tax assessors usually use more than one of the above approaches to be sure the final estimate of value is correct.

Keep in mind that building and land are appraised separately. Most states have systems in place in which a property is reassessed or revalued periodically. Then, the higher your property is valued, the higher the property tax. Property taxes in most states are typically paid twice a year.

Property tax is a large, fixed expense. Even though taxes aren't billed monthly, you should account for them when you are doing your monthly budgeting. Some owners have the taxes and insurance included in their mortgage each month. This is known as an impound/escrow account, and is one way to ensure you have the money for these large sums of money due twice per year. Don't be late with your property tax payments, as the penalties are usually around 10 percent. Several states allow you to charge the installments on a credit card at no additional

Bright Idea

It is a good idea when purchasing a property to take a good look at the details of the tax bill. All the taxes are broken down in detail. Sometimes, you may see special assessments, such as school bonds. If you don't understand something, don't be afraid to ask.

charge, and if you have a special credit card where you accumulate points or airline mileage each month based on your charges, your points can add up quickly if you pay your property taxes this way.

Many lenders address non-payment of property tax within the loan paperwork and have the ability to recall your loan, making it due and payable immediately if you don't pay your taxes.

Some localities also have personal property taxes. So if you leave a refrigerator, washer/dryer, or other furniture and fixtures in the property, you will have to report these as well. Usually, the best source is to contact the city or county government for a full list of taxes assessed or ask your accountant.

Transfer tax

This tax is generally levied at the time of a property sale. It is usually charged by the city, and the rate varies in each area. This amount is usually taken out and accounted for in the escrow process of purchasing or selling any property.

Depreciation

In calculating your income tax obligation each year, the government allows rental property owners to take a deduction for depreciation. Understand that depreciation is not an out-of-pocket expense you incur. Rather, it is an accounting concept that allows you to deduct normal wear and tear and is a way to shelter income. This is designed to not only help with normal wear and tear but also provide you more cash flow. And it doesn't have to do with the way your building is showing its wear and tear.

Watch Out!

Depreciation is allowed only on your building, not on the land. The amount of deprecation varies, depending on the type of property and when it was purchased. A good accountant can ensure you get the proper depreciation. This is one expense you want to be sure to write off.

Hiring an Accountant

Hiring a good tax accountant is an important part of the whole picture. You want an accountant who can assist and direct you to maintain good records in order to comply with federal, state, and local tax laws. The accountant also needs to be familiar with real estate law and have a good understanding of all rules and regulations.

What does an accountant do?

- Files all property tax forms with the state and federal government.
- Helps you properly set up your business in the beginning.
- Ensures you're allocating your expenses correctly.
- Correctly handles the depreciation schedule.
- Assists with the disbursement if you have partners or investors involved.
- Writes off repairs and depreciates the major improvements.
- Knows your long-term plans for each investment property.

Like anyone else you hire, request clients' names and telephone numbers so that you can call for references.

One of the most important things is that you feel comfortable with his or her approach, background, and ability to take care of the accounting of and taxes for your rental properties.

Rates of depreciation vary with the class and life expectancy of the asset. For example, a building is depreciated over a long period of time, while a computer is depreciated over only a few years. There are limits set by law as to how long the life expectancy for certain items are. Don't guess or decide on your own how long the asset should last. Talk to your accountant.

Repairs versus renovations

The general rule is that repair expenses are tax-deductible in the year spent, while renovation expenses are spread out over a period of years. In other words, larger items must be depreciated over a period of years, while the smaller items can be fully deducted immediately from that year's tax return.

Passive versus active

It is important to know the difference from the IRS standpoint and for your tax purposes. If you are in the business of real estate and it is your primary career, there are no real restrictions on the dollar amount of losses you can claim and apply against your earnings.

Most people consider their rental property as a secondary career. If this is the case, the IRS has a limit of $25,000 on annual loss deductions. Generally speaking, if you are what some refer to as a silent partner, you are a passive investor. As a passive investor, you can use the depreciation deduction to offset any profit from your property.

You are, by IRS standards, actively involved in the decision-making of your rental property, even if you have a professional management company in place. If you are assisting in making decisions regarding such things as major repairs, final selection of your tenants, or rental amounts, you are considered an active investor.

There are many creative ways to ensure you are getting all the advantages and full write-offs available through your knowledgeable accountant.

Business licenses and permits

Building permit fees are a very popular tax with city government. The charge is usually based on a percentage of the total improvement costs for the new construction.

Business licenses are becoming more common as a requirement for rental properties. In some cities or counties, you need to have a business license for each property you own. They calculate the number of units and the income generated, and charge you either a flat rate per unit or a percentage. This amount is generally due annually. Check with your local city or county offices.

Insurance

If you rent out property, you need a landlord's insurance policy. Often, ordinary homeowner's insurance doesn't cover rental property, even if your own residence is in the same building. As a landlord, you have a substantial investment in the property you rent to others and little control over the physical damage that can happen to it. You need to have high-quality rental property insurance featuring protection against fire, vandalism liability, and most other physical losses. Not only do you need to have insurance against these losses, but you also you need to be concerned about lawsuits and having the proper insurance to cover you to defend yourself and protect your assets.

It is imperative for you to maintain a sufficient amount of insurance that will cover them if anything happens to the rental property. An owner who is not adequately protected can face catastrophic financial problems. Insurance is one of the three major expenses you have as a rental property owner, along with your mortgage and taxes.

Like taxes, insurance is one of your major fixed expenses and is something you must have. You have an option to pay the insurance along with your mortgage in the same way as your taxes, with what is called your impound or escrow account. The amount of the annual insurance is calculated monthly, and you pay that amount when you pay your mortgage each month.

Keep in mind that different insurance carriers offer different types of coverages. You need to shop around or hire an insurance agent who will shop around for you. The agent

Moneysaver

Don't be afraid to get another quote from a different insurance company. When you shop around, make sure you're comparing apples to apples. Insurance varies a great deal, especially in the coverage and in the deductibles. Also make sure you review your insurance coverage with your agent at least once a year.

should take the time to explain the coverage and each detail so you know the advantages and disadvantages.

Include coverage for loss of rental income if your property can no longer be occupied due to a covered loss. For instance, if a pipe breaks and causes so much damage that your tenant has to move out for the repairs to be completed, you want that lost revenue reimbursed to you by the insurance company. In addition, purchase additional coverage for furnishings and appliances that are located at the residence. Your personal property will be insured for the direct physical loss caused by any of the perils (fire, flood) listed in your policy.

Types of insurance

Getting insurance is just as important as getting a good loan, and you need the proper coverage for your situation, something a good insurance agent can help you decide. When you figure out what coverage you need in order to satisfy and comply with your lender, shop around. Make sure that you're comparing apples to apples; for example, be sure that the deductibles are all the same when comparing policies.

- **Fire and liability** Most lenders require you to carry both fire and liablity insurance for your rental property, as this is their safety net. The insurance is designed to protect both you and the lender in the event of an unforeseen occurrence. If there is a fire in your property, you want the ability to rebuild and restore your property as close to the original condition as possible. Even a small fire can be quite costly. Be sure you have liability coverage as well as replacement coverage. Liability and fire insurance is a must. Period.

- **Umbrella coverage** This insurance is also known to some as blanket coverage. It is a very cost-effective way to decrease your risk, and it is designed to supplement your other policies. If you were involved in a large lawsuit that was above and beyond your coverage amount, the umbrella policy would kick in as secondary insurance and your backup. This is also used by owners of condominiums who cannot be covered by the standard fire insurance. In that situation, you must cover yourself for liability, even if the homeowner's association covers the fire insurance.
- **Flood insurance** This insurance is needed by more people than you may think. Insurance companies sell this coverage separately from your other insurance and is considered a rider policy. Inquire if your property is in a flood plain at the time you purchase your property (this information is usually disclosed during this time). Most lenders require flood insurance if it is determined that your property is located in a flood plain.
- **Natural disaster insurance** Earthquake, wind, hail, and hurricane insurance is another item that is sold separately as a rider to your current policy. This insurance obviously is not needed in all areas and is completely optional. Earthquake insurance is expensive and usually has a very large deductible.
- **Mortgage insurance** This is an insurance that pays off the balance of your mortgage in the event that you cannot make the payments for reasons such as a disability or death.
- **Workers' compensation** This insurance is necessary if you have any employees, even temporary ones. It is to protect you if an accident occurs in the performance of a maintenance or professional task related to your property,

as you could be liable for the person's medical bills and loss of wages. This policy protects your on-site manager (if you have one) and any workers who are on the property. You may think you don't have any employees for your rental properties, but in the eyes of the law you do. That unlicensed and uninsured handyman or a friend who works on your property and receives payment is technically an employee. Workers include the tenant who is showing your vacant unit. If you are hiring licensed workers, verify they are carrying their own worker's compensation policy for their employees.

- **Non-owner auto liability** This insurance is a very inexpensive policy that will cover you if someone working for you is driving. This coverage protects you from liability for accidents and injuries caused by the employee while working and using his or her own automobile.
- **Building ordinance coverage** This is an important coverage, as it will protect you in the event your rental property is partially or fully destroyed. It covers the cost of demolition and clean up, along with the increased costs you will incur if the property needs to meet new or stricter building code requirements.
- **Renter's insurance** This is an insurance paid for by your tenants. It is important to include in your rental agreement an explanation to your tenants that their personal belongings aren't covered by your policy. Most residents have the mistaken impression that an owner's insurance provides coverage for the resident's belongings. Renter's insurance usually covers losses of the tenants' personal belongings as a result of fire, theft, water damage, or other loss. It also provides protection against claims made by injured guests. Be sure to inform your tenants they aren't covered by your policy and encourage (or require) them to obtain their own insurance. Explain the benefits of this coverage and that it is usually quite affordable.

- **Home warranty insurance** This is offered to cover any failures of systems in the property. It usually covers plumbing, electrical, appliances, garage doors, and the furnace. If something breaks, you call the home warranty company to take care of the problem. Of course, many want to be paid for the service call — usually $30 to $40 at the time of service. However, this insurances can help protect you from a large expenditure, like replacing a furnace. If your property has been built in the last five years, this may not be needed. You need to determine how old the systems are.

Reducing risk through preventive maintenance

Why wait for a problem to arise or a lawsuit to hit you? Take the time to walk your properties, take care of your repairs, and have a proactive, preventive attitude. Walk around your properties and look for problems, check lighting, and look at the sidewalks for trip hazards. Look for any physical and health hazards and that potential lawsuit waiting to happen. Quite simply, the cost to take care of repairs and risks will be considerably less costly and time-consuming than any lawsuit, court costs, and medical bills.

Cut your losses before they happen. Make your property safe and avoid going through a stressful and expensive lawsuit.

Reviewing your policy

Don't just pay for the insurance each year. Take the time to review your coverage with your insurance agent. If you have hired an insurance agent, ask him to shop other carriers. Plan to review your insurance coverage the same time each year. Each March, for example, I meet with my insurance agent. I gather all the policies and meet at my office to review everything. Time can lapse quite quickly and before you know it — and usually when it is too late — you find you are underinsured and don't have the proper insurance coverage for today's values. Protect your investment with too much insurance.

Having proper insurance is a very important part of owning rental property.

Just the facts

- Paying taxes, obtaining licenses, and having insurance are a requirement of owning rental property.
- It is important to comply with all federal, state, and local tax and licensing requirements.
- Hiring a good tax accountant will save you more than money.
- Both state and federal tax laws are forever changing.
- It is a good idea to meet with your accountant and your insurance agent at least once a year for an overview and review of your rental property needs.
- Use depreciation to shelter your income.
- Be an active investor to reduce your taxes.
- Insurance is there to protect you and your investment.
- More and more local governments have put a business license fee in place for rental property owners for each property.
- You are responsible to have workers' compensation insurance for anyone you hire who is not an independent contractor carrying his own insurance.
- Renter's belongings aren't covered by an owner's insurance policy. It is a good idea to not only put that in writing but also to encourage (or insist) that your tenants obtain renter's insurance.
- Reduce risk by keeping your property safe.