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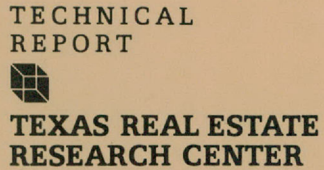

TECHNICAL
REPORT

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Tax and Recordkeeping Guide for Real Estate Licensees

TAX AND RECORDKEEPING GUIDE
FOR REAL ESTATE LICENSEES

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TAX AND RECORDKEEPING GUIDE

FOR REAL ESTATE LICENSEES

Most real estate brokers and salespersons understand the benefits that organization and preparation have in increasing sales. Similarly, organization and preparation are important with respect to taxation. Most taxpayers spend approximately one-third of their working hours earning money to pay taxes. This booklet is designed to help organize records and minimize federal tax obligations. Readers may wish to use the schedules in this booklet or make copies of them. Complete these schedules, and keep all supporting documents. Remember, the best type of income is tax-saved dollars--those are not taxable.

For a taxpayer to take advantage of favorable features of the tax laws, adequate books and records must be maintained. In a recent court case, a taxpayer was not allowed to use a special method because his books and records were inadequate. If taxpayers keep only such records as to permit the taxpayers to determine income on a cash method of accounting, apparently they cannot complain if the Internal Revenue Service (IRS) determines their income under the cash method. "Where no systematic records and bookkeeping practices are employed, use of the accrual method of accounting is not allowed ... and the taxpayer is presumed to be on the cash method of accounting."[1]

The type of records that should be maintained by a licensee is not specified in the law. Such records need not be elaborate or formal. Simplicity of recording should encourage prompt entries as income is received and payments for any deductible expenses are made. Sales slips, bills, invoices, receipts, cancelled checks and other documents often are sufficient evidence to support deductions claimed on a tax return. Dates of sales and purchases of real estate are important because of the importance of the long-term and short-term classification.

At a minimum, records should be maintained for at least four years after the due date of the tax return or the date the tax is paid, whichever is less. Because of the importance of the income averaging rules, records probably should be kept from six to 10 years. Returns of prior years can greatly simplify preparation of a current return. For more information, write for a copy of Guide to Record Retention Requirements, G.P.O., Washington, DC 20402. The cost is $2.

Keep copies of completed tax returns in a safe place. Although photocopies of income tax returns can be obtained from the IRS for $5, the wait of about six weeks can be costly. There is a charge of $2.50 for a transcript of tax account information. To make these requests, complete Form 4506, Request for Copy of Tax Form, and mail it and the prepayment to the address shown on the form.

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1 Under the accrual method, income is taxable in the year when all the events have occurred which fix the right to receive such income and the amount can be determined with reasonable accuracy.

SELF-EMPLOYED VERSUS EMPLOYEE

Most real estate brokers and salespersons are independent contractors (IC) rather than employees of the firm that sponsors them. Commissions from real estate services are business income, and any expenditures incurred in rendering such services are deductible as business expenses. Since an independent contractor is not an employee, such a broker or salesperson is self-employed. However, if the broker or salesperson operates in corporate form or is a 10 percent or greater partner in a partnership, such a person is treated as an employee for tax purposes. See Appendix 1 for major attributes of the various business organizations.

An employee relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. In essence, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done.

The advantage of an IC relationship from the point of view of an employer is the avoidance of four tax responsibilities:

1. Paying unemployment taxes under the Federal Unemployment Tax Act (FUTA).

2. Matching Federal Income Contributions Act (FICA) taxes.

3. Withholding social security taxes under FICA.

4. Withholding federal income taxes.

The Tax Equity and Fiscal Responsibility Act of 1982 provides that real estate agents and direct sellers shall be classified as independent contractors. In order for a real estate agent to be classified as an independent contractor, two conditions must be met:

1. Substantially all of the income for services as a real estate agent must be directly related to sales or other output.

2. The services are performed under a written contract that provides that the agent shall not be treated as an employee for federal tax purposes.

Whether an individual is self-employed or an employee determines the method of reporting income and expenditures. Commission income for a self-employed person is shown on IRS Form 1099 NEC. Deductions for business-related expenditures are listed on Schedule C (Form 1040). In effect, expenditures are treated as deductions <u>for</u> adjusted gross income. However, an employee deducts most business-related expenditures as itemized deductions on Schedule A (Form 1040). Thus, if an employee's itemized

deductions do not exceed the zero bracket amount,[2] the deductions are, in effect, lost forever. An employee may deduct travel and moving expenses as deductions for adjusted gross income.

ESTIMATED TAXES

Unlike an employee, a self-employed person is not subject to withholding of income taxes and social security taxes (FICA). Instead, a self-employed person must estimate total income for the year and pay the appropriate estimated tax to the IRS in quarterly installments. The four estimated payments for the calendar year 1984 are due by April 16, June 15, and September 17, 1984, and January 15, 1985.

A licensee will normally receive commission income during the year and receive a Form 1099 from the firm in January stating total commission income. But during the year, a licensee must file a quarterly declaration of estimated taxes on Form 1040 ES along with the appropriate payment. Page 2 of Form 1040 ES provides a worksheet to compute estimated income tax for the subsequent tax year. If the estimated tax is $300 or more for 1983 ($400 in 1984 and $500 thereafter), a licensee is instructed by the form to pay the estimated amount in four installments. If the estimated payments are not made when due, a nondeductible penalty of the underpayment will be imposed by the IRS. In general, if a licensee pays at least the tax on last year's income (at this year's rate) or pays at least 80 percent of the current year's tax, this penalty can be avoided.

SCHEDULE C: BUSINESS-RELATED INCOME AND EXPENSES

As mentioned previously, the business-related income and expenses of a self-employed licensee are reported on Schedule C. One of the first questions on Schedule C is whether the self-employed taxpayer uses the cash, accrual or some other method of accounting. Most licensees will use the cash method of accounting in preference to the accrual method. In essence, under the cash method, income items are taxable for the year in which they are actually or constructively received, and expenditures are deductible in the tax year in which they are actually made. The cash method allows a great deal of flexibility in accelerating or deferring the receipt of income and the hastening or postponing of the deductibility of expenses through the timing of payments.

Part I of Schedule C is used to report commission income (from Form 1099 received from the licensee's sponsor) and other business income. Remember that most other items will appear on other forms. For example, wages appear on page 1 of Form 1040, interest and dividends on Schedule B, capital gains and losses on Schedule D and rental income on Schedule C for each self-employed activity.

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[2] For 1984, a single taxpayer and head of household have a $2,300 zero bracket amount (ZBA), a married person filing separately has a $1,700 ZBA and a married person filing jointly has a $3,400 ZBA.

Part II of Schedule C is used to report the allowable business deductions. The law allows a deduction for all the ordinary and necessary expenses paid or incurred during the tax year in carrying on a trade or business. The expenditures must be reasonable. Many of the expenses on Schedule C and listed below are self-explanatory:

- Advertising
- Car and truck expenses
- Commissions
- Depreciation
- Dues and publications
- Employee benefit programs
- Insurance
- Legal and professional fees
- Office supplies and postage
- Travel and entertainment
- Utilities and telephone

Several of these expenditures are discussed below. Note, any net profit or net loss on Schedule C is carried to the front page of Form 1040.

Tax deductions are quite valuable to a licensee. Each extra deduction is worth approximately the same percentage of each dollar as the licensee's top tax bracket. For example, within the 50 percent tax bracket, an extra $1,000 of deductions yields approximately a $500 tax-savings on the federal income tax return.

Be cautious in claiming deductions that may be attributable to real estate professional activities. If a deduction is questioned, proof of its relationship to real estate business may be required. For example, if a taxpayer takes a vacation to Miami or Las Vegas and just happens to contact some "clients" or "look at real estate," no attempt should be made to deduct vacation expenses. Do not be greedy. Of course, the cost of traveling to and from and participating in a legitimate real estate convention is deductible.

TRANSPORTATION EXPENSES

Transportation expenses are a major expenditure for a licensee. As a general rule, commuting expenses are not deductible. Thus, the cost of traveling from a person's residence to the office is not deductible. Once at the office, however, any additional business travel is deductible (i.e., driving a prospective purchaser to various sites).

Further, according to the tax court, a taxpayer may deduct transportation expenses incurred when traveling from work to home to another place of work if the taxpayer's home is the principal place of business.

Example: Taxpayer operates a real estate rental business out of own residential office. The Tax Court's position is that because the personal residence is the rental business "tax home," then all trips from the residence to various rental properties are deductible transportation expenses. The IRS does not necessarily accept this position.

If possible, a licensee should have one automobile to be used exclusively for business purposes. The placement of the name of the real estate agency on the sides of the auto should help in sustaining a transportaion deduction on audit.

Each year, an employee or self-employed licensee has an option to deduct, in lieu of actual expenses (i.e., out-of-pocket expenditure approach plus depreciation), local or overnight travel at a rate based on mileage. For tax years after 1982 the rate was increased to 20.5 cents per mile (up from 20 cents) for the first 15,000 miles of business use and 11 cents thereafter. The IRS issued an interesting ruling concerning application of the 20.5 cent rate. Specifically, a husband and wife who are self-employed in separate businesses and owning cars separately can each get the 20.5 cents per mile rate on the first 15,000 for each auto. This rate applies although they file a joint return.

If the automobile is depreciated fully, the lower 11 cents per mile must be used. Parking fees and tolls also may be added to the standard amount. If, as an employee, any reimbursement is less, the taxpayer can deduct the excess of these permitted ceilings over the reimbursement received.

The IRS takes the position that an automobile is fully depreciated after 60,000 miles. Thereafter the optional deduction is limited to 11 cents per mile. Under the new Accelerated Cost Recovery System (ACRS), an automobile can be written-off over three years: 25 percent in the first year, 38 percent in the second and 37 percent in the third year (see Table 1). In most situations, a licensee should receive a greater deduction using the actual expenditure approach and deducting depreciation under ACRS. In either case, an investment tax credit of 6 percent would be available. However, accurate records must be maintained, such as the mileage log shown in Appendix 4.

A licensee may immediately deduct the entire cost of new or used tangible personal property up to $7,500 in 1984 and 1985 ($5,000 in 1982 and 1983) per year. For example, a licensee may immediately deduct up to $7,500 of an automobile or computer rather than depreciating them. However, no part of the cost of this expensed property is subject to the investment tax credit. In most cases, the immediately expensing election is not advantageous.

Allocation is necessary where an automobile is used both for business and personal purposes. Some form of diary should be kept in the car to document the miles driven for business purposes. For example, a licensee should record the mileage of the auto on January 1 and December 31. If the diary indicates that the auto is used 60 percent of the time on business, then 60 percent of the expenditures (including depreciation) would be deductible. Or for the optional method, 60 percent of the mileage during the year would be considered business miles for use in computing the standard mileage amount.

TRAVEL AND ENTERTAINMENT EXPENSES

Another important expenditure of a licensee is travel and entertainment expenses. Traveling expenses incurred while away from home (such as air fares, meals and lodging) and many entertainment expenses are deductible. There are several ways to deduct travel expenses. Most employees who account to their employer for purposes of reimbursement use the 100 percent method. But for each expenditure the taxpayer must maintain data or a diary substantiating:

Table 1

RECOVERY PERCENTAGES FOR CERTAIN PROPERTY

If the recovery year is	The applicable percentage for the class of property is: Personal Property 3-year	5-year	10-year	Buildings* 15-year
1	25%	15%	8%	12%
2	38	22	14	10
3	37	21	12	9
4		21	10	8
5		21	10	7
6			10	6
7			9	6
8			9	6
9			9	6
10			9	5
11				5
12				5
13				5
14				5
15				5

* See Appendix 2 and 3 for detail based on the month of acquisition.

1. Amount
2. The time and place of travel or entertainment
3. The business purpose
4. The business relationship to the taxpayer of each person entertained.

Basically, "no records, no deductions" describes the position of the tax laws with respect to travel and entertainment expenses.

In addition, a receipt must be obtained where practicable for any expenditure for lodging while away from home and for any other expenditure of $25 or more. If the documentation and business purposes are not within the prescribed requirements of the law, it is possible under certain circumstances that the business will be denied a deduction, and the recipient, even if only in an employee's status, will be deemed to have taxable income in the amount of any reimbursement received.

There is a short-cut method that can be used in lieu of accounting for the actual amount spent. Certain reasonable per diem allowances for travel away from home and mileage allowances may be deducted if all the other substantiation requirements are met (for example, time and place of travel). For substantiation purposes and reimbursement from the employer, the IRS will accept a per diem amount (including meals and lodging) not in excess of $44 per day.

Even more than $44 per diem is possible. If the per diem rate authorized by the U.S. government for federal employees in the locality where the travel occurs is higher, the higher amount can be used. For example, in Berlin it is $86; in Hong Kong, $100; and in London, $108.

Keep in mind even if the per diem amount is used, an agent must substantiate the time, place and business purpose of expenses. In addition to the daily allowance while away from home, a real estate agent can be reimbursed for transportation costs to and from the destination. However, if an agent owns more than 10 percent of the brokerage firm's stock, that agent cannot use the per diem method.

Travel expenses are the ordinary and necessary expenses of foreign and domestic "travel away from home" overnight in pursuit of business or employment. In determining if a taxpayer has a home or is an "itinerant," there are three objective factors that may be used. These factors are as follows:

1. Whether the taxpayer performs a portion of business in the vicinity of this claimed abode and uses such abode (for purposes of lodging) while performing such business there;

2. Whether the taxpayer's living expenses incurred at the claimed abode are duplicated because business requires the taxpayer to be away therefrom; and

3. Whether the taxpayer

   (a) has not abandoned the vicinity in which historical place of lodging and claimed abode are both located,

   (b) has a member or members of his or her family (marital or lineal only) currently residing at the claimed abode, or

   (c) uses a claimed abode frequently for purposes of own lodging.

The IRS recognizes that a taxpayer has a "home" for traveling expense deduction purposes if the taxpayer satisfies at least two of the three objective factors set forth, and thus can be "away from home" for purposes of Internal Revenue Code Section 162(a)(2). When "away from home" overnight, many other expenditures--such as travel, transportation, meals, lodging or laundry--are deductible.

To determine if a taxpayer is away from home, it is necessary to know what is meant by "home" for tax purposes. The IRS has argued consistently and the courts generally have agreed that a taxpayer's home for tax purposes is the place of business. However, if the taxpayer has no "tax home," the taxpayer cannot be away from home. If the new location is temporary, as opposed to indefinite, the tax home is the home or original place of employment.

In general, if a licensee is not away from home, meals and other living expenses are not deductible. However, by adding a business purpose, meals and entertainment expenditures become deductible. For example, taking a prospective seller to lunch allows a licensee to deduct the cost of both meals. A daily diary should be used to support and document entertainment expense. A sample diary can be found in Appendix 4.

There is an optional method which permits the use of a standard per-day amount to calculate deductions for meal expenses while away from home on business travel. Thus, the real estate agent does not have to keep records of the amount of each expenditure.

This optional election is made on a yearly basis and is made merely by using it. The standard amount is (1) $14 per day for travel that requires a stay of less than 30 days in one general locality, or (2) $9 per day for travel that requires a stay of 30 days or more in one general locality. On a day that business travel begins or ends, one-fourth of the standard amount can be taken for each six-hour quarter of the day during any portion of which the licensee is either traveling or away from home. These quarters are (1) midnight to 6 a.m., (2) 6 a.m. to noon, (3) noon to 6 p.m., and (4) 6 p.m. to midnight.

When a licensee is reimbursed for meals, the standard amount may be used only where (1) there is a separate amount reimbursed for meals (not a per diem amount for both meals and lodging combined); (2) the licensee reports the reimbursement as income; (3) the licensee is not required to account to the employer for the amount spent on meals; and (4) the real estate agent is not related to the employer within the meaning of Section 267(b).

Club dues are deductible if the membership is used primarily to advance the cause of the taxpayer's real estate business. Such primary use is established if the taxpayer can demonstrate that the club facilities are used more for business purposes than for pleasure. Even though the dues may not be deductible because the primary use test is not met, a deduction may be allowed for "quiet business meals" or entertainment associated with a business discussion. Payment of club dues by an employer will not constitute income to an employee or independent contractor. Complete records should be maintained to substantiate the deduction for both dues and meals.

In general, no deduction is allowed for business gifts made by a licensee to an individual to the extent that the cost of the gifts to the individual exceeds $25 per year. The $25 maximum applies to each individual to whom a gift might be given. For example, assume that a licensee gives an individual a set of golf clubs during 1984. If the set had a cost of $300, the taxpayer can take only a $25 deduction for the gift. Advertising signs or displays that a licensee distributes are not treated as gifts but rather are deductible in full as business expenses. Gifts of novelty advertising articles imprinted with the licensee's name and worth $4 or less apiece, (i.e., a calendar, ballpoint pen or wooden nickel), do not have to be taken into account for the $25 ceiling.

HOME-OFFICE EXPENDITURES

Suppose licensees set aside a small portion of their home to store realty magazines, books, supplies and other materials. Likewise, they have a desk, filing cabinet, safe, typewriter and other equipment that are used in their real estate business. Such items, plus a portion of their home in the form of depreciation, may be deductible. However, the space that they set aside must have been used only on a regular basis for real estate business and not for general living purposes.

For tax years beginning after December 31, 1975, the home-office expense deduction became more elusive. After this date, a licensee is not entitled to deduct any expenses attributable to the use of a home for business purposes unless they are attributable to the use of the home (or separate structure) and used exclusively and on a regular basis as (a) the taxpayer's place of business or (b) a place of business that is used by customers in meeting or dealing with the taxpayer in the normal course of business. In addition to these requirements, an employee's business use of a residence must be for the convenience of the employer. A self-employed real estate person would not have to meet this tough convenience-of-the-employer requirement.

A specific part of a taxpayer's home must be used solely for the purpose of carrying on a trade or business to satisfy the exclusive use test. This requirement is not met if the portion is used for both business and personal purposes. An exception is provided for a licensee whose dwelling unit is the sole fixed location of a trade or business. In such case, the ordinary and necessary expenses allocable to space within the dwelling unit that is used as a storage unit for inventory and equipment are deductible provided that such space is used on a regular basis and is a separately identifiable space suitable for storage.

If a taxpayer engages in more than one trade or business, a 1981 retroactive law change allows a deduction for business use of a home for activities other than the taxpayer's primary business. However, deductions are not allowed for taxpayers who have only one business activity and take work home from the office, nor for taxpayers who do bookkeeping and other work at home with respect to their investments.

Deductions for home-office expenses cannot generate a loss. Allowable expenses attributable to the business use of a taxpayer's home may not exceed the amount of gross income derived from such business use. Deductions that are allowed without regard to their connection with the taxpayer's trade or business, such as mortgage interest and real estate taxes, reduce the gross income for these purposes.

For example, suppose a taxpayer lives in a suburban home that includes an office and maintains real estate in a nearby city. The office at home is devoted exclusively and on a regular basis to the accommodation of local clients. Or, suppose the licensee has two businesses and uses a home office for a real estate business. The gross income from the home office is $3,000 annually. The home mortgage interest is $3,000, and the real estate taxes on the home are $2,600. Other home expenses, such as the cost of heating, water, telephone, electricity, air conditioning and similar expenses and depreciation, amount to $7,200 for the year. Assuming a one-fourth allocation of such expenses to the home office (a proper allocation is based on square footage or room use), $1,400 of the interest and taxes and $1,800 of the other expenses would be allocable to the home office. The deduction for the home office would be $1,600, computed as follows:

1.	Gross income from home office	$3,000
2.	Less allocable portion of interest and taxes	-1,400
3.	Limit on remaining expenses	$1,600
4.	Deductible expenses (lesser of actual expenses $1,800 or amount of line 3)	$1,600

As in all instances where a taxpayer deducts a valid expense, records must be available to substantiate the home-office maintenance deduction. If a personal residence is acquired, it is advisable to retain the details of the original purchase (such as the price and closing costs). Likewise, data concerning all capital improvements should be preserved along with receipts or cancelled checks supporting each item. This information increases the adjusted basis in the property and may thereby increase the depreciation deduction. An increased adjusted basis will, of course, reduce any gain to be recognized in the event of a taxable disposition. See Appendix 4 for a sample home-office expense diary.

The basis of computing depreciation (or loss from sale) of property converted to business use is adjusted cost basis or fair market value (FMV) on date of conversion, whichever is lower. Thus, a good record to procure and retain (when FMV is below cost) would be a convincing appraisal report covering the fair market value of the residence at the conversion point. Obviously, the report should make an allocation of value between lot and

building to avoid any later problem involving the depreciation allowance. Depreciation is reported on Form 4562. Under ACRS, real estate such as a business-home office can be written-off over a 15-year recovery period. Only the business portion of a home can be depreciated. See Appendix 2 for a table of annual depreciation percentages.

Cancelled checks, receipts and other evidence of the expenditures should be retained in a safe place. This substantiation is important in determining what pro rata portion of such items as rent, utilities, taxes and interest on a mortgage are deductible. Of course, no portion of purely personal expenses pertaining to a family household is deductible. For example, the cost of repairs that do not benefit the part of the residence used for business purposes (i.e., painting other rooms or expenditures for lawn care) is not deductible. But a pro rata portion of painting the outside of the residence would be deductible. However, only if a taxpayer has adequate substantiation will these deductions be allowed.

Do not forget the telephone bill. The portion of the phone bill that is allocable to your real estate business is a fully deductible expense. Keep those monthly itemized phone bills, and consider installing another phone in the home office to be used only for business.

NOTE: A real estate broker may have a better chance at claiming a home-office deduction than a salesperson. A salesperson may not be able to work without a broker's supervision and, therefore, the home office may not be the principal place of business. Use of the home office frequently to meet clients is a favorable factor in obtaining a deduction.

Caution: There is a major disadvantage of a home office. To the extent that a home is used partially as business property, a taxpayer may not postpone a portion of any gain when a residence is later sold and another residence is purchased within 24 months. For example, if a licensee claims one-sixth of a house as a home office, on a later sale of such residence one-sixth of any gain may not be postponed under Internal Revenue Code Section 1034; normally, however, the gain is capital gain, exclusive of any depreciation recapture. This same disadvantage may apply to a licensee, age 55 or over, electing nonrecognition of gain from the sale of a principal residence. Unlike any loss associated with the five-sixths residence portion, loss on the business portion is deductible (generally as an ordinary loss).

OTHER EXPENDITURES

Treasury Regulation Section 1.162-5 permits an income tax deduction for educational expenses (registration fees and cost of travel, meals and lodging) undertaken to: (1) maintain or improve skills required in one's employment or other trade or business or (2) meet express requirements of employer or law imposed as a condition to retention of employment, job status or rate of compensation. For example, a licensee might attend a real estate or tax course at a university or college or a course on advertising, management or some other subject which might be beneficial in the trade or business. These expenditures generally are deductible.

Supplies are deductible; however, any supplies on hand at the end of the year are not deductible. They are assets to be carried over to the next year.

A licensee may incur some advertising expenses. Note, an accrual basis licensee normally must deduct advertising expenses in the year incurred even though the advertising program extends over several years. Records should be kept to show any advertising expenses that are incurred to sell real estate.

The position of the IRS is that the cost and expense of maintenance of uniforms are generally allowable where "(1) the uniforms are specifically required as a condition of employment (or obtaining business), and (2) are not of a type adaptable to general or continued usage to the extent that they take the place of ordinary clothing." If the cost of clothing is deductible, it generally is held that the expenses of laundering or cleaning also are deductible. No clothing deduction is allowed merely because the employee's occupation is such that the clothing worn at work becomes soiled quickly, is subject to unusual wear and tear or must be extra heavy because of the climate. If a particular color and type of uniform is required of a licensee, such clothing should be deductible.

Realty-related books and publications should be deductible. Subscriptions, such as to the Wall Street Journal, Barrons, and Real Estate Review could be deductible. A calculator and other small tools could be deductible. A small home computer used only for business purposes could be depreciated over a five-year period.

Dues and fees paid to realty-related business organizations are deductible. Accounting and legal advisory services and secretary salary should be deductible. A sample miscellaneous expense diary is in Appendix 4.

A checklist of potential deductible expenditures are listed below:

Accounting
Advertising
Appraisal fees
Auto mileage
Brief case
Calculator
Casualty loss
Club dues
Computer (depreciate)
Dues (professional)
Educational expenses
Employment agency fees
Entertainment
File cabinet (depreciate)
Gifts (business)
Home-office expenses
IRA contributions
Keogh plan contributions
Laundry (away from home)
Legal
Lodging
Meals
Moving expenses
Parking fees/tolls
Publications (business)
Safe deposit box
Salaries for employees
State and local taxes
Supplies (i.e., paper, pencils)
Tax return preparation
Tools
Transportation
Travel
Typewriter (depreciate)

SELF-EMPLOYMENT TAX

The commissions received by a self-employed licensee are not subject to FICA withholding and matched FICA payment by an employer. However, a self-employed person must file Schedule SE and pay social security taxes if self-employment income is $400 or more. The profit calculated on Schedule C is carried to schedule SE. For 1984 the rate is 11.30 percent on the base of $37,500. Thus, the maximum FICA payment of a licensee in 1984 is $4,237.50. If a licensee also receives other salary or wages subjected to FICA, then the amount subject to self-employment taxes is reduced by the wages subject to the employer FICA tax.

Example:

Sally House worked for a local licensee during 1984 and earned commissions of $33,400. Futhermore, she earned $6,020 of wages as a substitute teacher (which were subject to FICA taxes). Only $31,480 ($37,500 - $6,020) is subject to the self-employed tax in 1984, resulting in a tax of $3,557.24 ($31,480 x 11.3%).

EMPLOYEE-LICENSEE

An individual licensee who is an employee (not an independent contractor) may incur two types of expenses:

1. Deduction for Adjusted Gross Income (DFOR), and
2. Deduction from Adjusted Gross Income (DFROM).

This first category is mainly composed of employment-related expenditures, such as moving expenses (use Form 3403), transportation expenses, travel away from home and so forth (use Form 2106). The second category, DFROM, is composed of nonbusiness type expenses, such as interest, taxes and contributions. A taxpayer may itemize deductions or claim the zero bracket amount when figuring DFROMs. For example, a single individual in 1984 may deduct the larger of (1) total itemized nonbusiness deductions or (2) the zero bracket amount of $2,300 on a separate return and $3,400 on a joint return. If a taxpayer uses the second alternative, none of the itemized DFROMs may be deducted. That is, if a licensee itemizes deductions, the zero bracket amount may not be used. Many of the expenditures discussed above for a self-employed licensee would be a DFOR on Form 2106 for an employee.

CHILD AND DEPENDENT CARE EXPENDITURES

To be able to work, a licensee may incur child-care expenditures. Beginning in 1982, there is a nonrefundable child and dependent care credit equal to 30 percent of employment-related expenses of taxpayers with incomes of $10,000 or less. The credit is reduced by one percentage point for each $2,000, or fraction thereof, of income above $10,000. For a licensee with adjusted gross income above $28,000, the credit rate is 20 percent. The maximum amount of employment-related expenses taken into account is $2,400 for one dependent and $4,800 for two or more dependents. Expenditures for

out-of-home, noninstitutional care of a disabled spouse or dependent also are eligible for the credit beginning in 1982. Such dependent care centers must comply with state and/or local regulations.

Table 2

CREDITS FOR CHILD AND DEPENDENT CARE EXPENDITURES

Adjusted Gross Income	Applicable Percentage	Maximum One Dependent	Maximum Two or more
Up to $10,000	30%	$720	$1140
$10,001 - $12,000	29%	696	1392
$12,001 - $14,000	28%	672	1344
$14,001 - $16,000	27%	648	1296
$16,001 - $18,000	26%	624	1248
$18,001 - $20,000	25%	600	1200
$20,001 - $22,000	24%	576	1152
$22,001 - $24,000	23%	552	1104
$24,001 - $26,000	22%	528	1056
$26,001 - $28,000	21%	504	1008
$28,001 and thereafter	20%	480	960

Example: Mr. and Mrs. Marita have adjusted gross income of $24,250. They incur $5,100 for child-care expenses for two minor children in 1984. Their credit for 1984 is $1,056 ($4,800 x .22).

Child care provided by an employer under a written nondiscriminatory plan is not included in gross income of an employee for tax years after 1981. Of course, none of this amount may be used by the employee for calculating a child-care credit.

KEOGH RETIREMENT PLANS

Self-employed individuals are permitted to set up qualified retirement plans. A self-employed licensee obtains a current deduction from gross taxable income in the amount of the annual contribution to such a defined contribution Keogh plan, but the annual deduction (after 1983) is limited to the smaller of $25,000 or 25 percent of earned income. Under a defined benefit Keogh plan, the benefit payable to an individual is limited to the smaller of $90,000 or 100 percent of the person's average compensation for the highest three years of employment.

For example, Johnson, a real estate broker on a calendar-year and accrual basis, is the sole owner of a real estate firm that nets $40,000 (after Keogh contribution). The maximum contribution to a defined contribution Keogh plan, deductible for adjusted gross income, is $10,000 (25% x $40,000).

A licensee may use a Keogh plan where income is earned as an independent contractor. An individual can contribute up to 25 percent of this earned income to a Keogh plan even while participating in a corporate pension plan

elsewhere as an employee. Earned income refers to salary, professional fees, book royalties and sales but does not include such passive income items as dividends or interest. Earned income is reduced by contributions to qualified plans on that individual's behalf.

In Table 3 below, it is assumed that the annual contribution at the end of the year is $7,500 and $15,000 with the fund earning 10 and 15 percent, compounded annually. For example, with an annual contribution of $7,500 for 30 years, a total of $1,233,705 would accumulate using a 10 percent rate. Thus, a Keogh retirement plan is a great tax shelter for an individual.

Table 3

H.R. 10 PLAN ACCUMULATIONS

	10% Rate		15% Rate	
Years	$7,500 Annual Contribution	$15,000 Annual Contribution	$7,500 Annual Contribution	$15,000 Annual Contribution
10	$ 119,527	$ 239,055	$ 152,277	$ 304,554
20	429,562	859,125	768,327	1,536,654
30	1,233,705	2,467,410	3,260,587	6,521,175

Many Keogh plans will be classified as "top-heavy" plans. For nondiscrimination purposes, these "top-heavy" plans must meet special vesting requirements, minimum benefit requirements and compensation limitations. Such plans primarily benefit an employer's key employees.

A licensee is a key employee of an employer if the individual is a participant in an employer plan and, at any time during the plan year or any of the four preceding plan years, (1) is an officer (if a corporate employer), (2) is one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5 percent interest in the employer or (4) owns more than 1 percent interest in the employer and has compensation from the employer in excess of $150,000.

INDIVIDUAL RETIREMENT ACCOUNT

Before 1982, persons participating in regular qualified pension and/or profit-sharing plans were precluded from participating in IRAs. Not so after 1981. Beginning in 1982 employees covered by a qualified plan or self-employeds covered by a Keogh plan now may establish their own tax-deductible IRA subject to the $2,000 (and, for spousal, $2,250) limits. Or if an employer retirement plan allows voluntary contributions, an employee may make deductible contributions to the employer plan, subject to the $2,000 or 100 percent of compensation limits. These IRA-type contributions are in addition to any nondeductible employee contributions. The deductible contributions may be split between an IRA or an employer plan.

Self-employed licensees may make additional deductible contributions to an IRA or Keogh plan. Thus, a self-employed person with earned income of $100,000 can contribute a total of $27,000 to a Keogh plan ($25,000 +

$2,000). Or the self-employed individual may contibute $25,000 to the Keogh plan and $2,000 to an IRA ($2,250 for spousal IRAs).

If both spouses work, each may establish an IRA and contribute a total of $4,000 per year. However, when only one spouse is employed, an IRA can be established for the nonemployed spouse if the employed spouse is eligible for an IRA. The maximum deduction for the individual and spouse is the lesser of 100 percent of the compensation income of the working spouse or $2,250. No more than $2,000 can be allocated to the working spouse and a joint return must be filed. Table 4 indicates the amounts that can be accumulated in two IRAs by a working couple. These figures assume $4,000 is deposited at the end of each year with annual compounding rates of 10, 12 and 15 percent. For example, over a period of 30 years a total of $657,976 can be accumulated in a couple's IRA's at an annual compounding rate of 10 percent.

Table 4

IRA ACCUMULATIONS

Years Contributed	10%	12%	15%
10	$ 63,748	$ 70,195	$ 81,212
20	229,100	288,208	409,774
30	657,976	965,328	1,738,980
40	1,770,372	3,068,364	7,116,360

A participant has a zero basis in contributions to an IRA since they are not taxed currently. Once retirement payments are received, such payments are ordinary income and are not subject to the 10-year averaging allowed for lump-sum distributions. However, a taxpayer can use regular income averaging. The value of undistributed proceeds of an IRA account is excluded from the gross estate of the participant if the proceeds are payable as an annuity to a beneficiary (other than the estate). Payments made to a participant before age 59 1/2 are subject to a nondeductible 10 percent penalty tax on such actual, or constructive, payments.

A Keogh or IRA participant may make a deductible contribution for a tax year up to the time prescribed for filing the individual's tax return, including any extensions of time. However, a Keogh plan must have been established by December 31 to obtain a deductible contribution in the subsequent year. For example, an individual could establish a Keogh plan by December 31 by placing a small amount in the plan. A much larger contribution could be made in the next year up to the time prescribed for filing the individual's tax return (including any extensions of time). On the other hand, an individual can establish and fund an IRA after the end of the tax year and still receive a deductible contribution for the prior year.

A tax-free rollover for distributions from qualified plans (as well as from another IRA) is an alternative to taxation of a lump-sum distribution or termination distribution. A distribution is not included in gross income if transferred within 60 days of distribution to an IRA or another qualified

plan. Further, any rollover amount in an IRA can later be rolled over into another qualified plan if the IRA consists of only the amounts from the original qualified plan. Remember that distributions from an IRA are not eligible for capital gain treatment and 10-year averaging treatment.

IRA and Keogh participants may self-direct their investments into a wide variety of assets. The participant self-directs the investments into various assets even though the assets are under the control of a trustee or custodian. For tax years after 1981, the acquisition by an IRA or self-directed Keogh or corporate plan of collectibles (i.e., art, gems, paintings, metals) is treated as a distribution (i.e., taxed). For an IRA or Keogh participant under age 59 1/2, there would also be a 10 percent premature distribution penalty.

LEGAL AND ILLEGAL TAX AVOIDANCE

A taxpayer has a right and should try to avoid taxes. However, there is a difference between tax avoidance and tax evasion. Tax avoidance describes tax reduction methods permitted by law. Tax evasion is any method of reducing taxes that is not permitted by law, and which carries heavy penalties. Avoidance is "playing the game" according to the rules. Evasion is breaking the rules of the tax "game" which is a criminal offense.

The IRS has civil as well as criminal sanctions for violations of the tax laws. Civil sanctions are assessed in addition to the tax liability, but they are not considered to be felonies (i.e., criminal violations). These civil penalties include (1) the 5 percent-per-month delinquency penalty for failure to file a return or a timely return--which is not to exceed 25 percent; (2) the 5 percent penalty for negligence or intentional disregard of rules and regulations without the intent to defraud and (3) the 50 percent penalty on an underpayment on any portion that is due to fraud. The purposes of this 50 percent noncriminal fraud penalty is to give the IRS a strong civil sanction that can be imposed without incurring the time and expense usually required in the prosecution of a criminal violation. Ostensibly, the 50 percent fraud penalty is to "reimburse" the government for the cost of discovering and investigating fraudulent violations of the tax laws. Beginning in 1982, there is a penalty equal to 50 percent of any interest payable on the part of the underpayment attributable to negligence or intentional disregard.

The criminal sanctions provide punishment for severe offenses and generally involve imprisonment, fines or both. For example, a taxpayer who willfully attempts in any manner to evade or defeat a tax may, if found guilty of a felony and convicted, be fined not more than $10,000, imprisoned not more than five years or both. In addition, the convicted taxpayer usually must pay court costs. Both civil and criminal sanctions may be imposed for the same offense. The difference often seems to be a matter of whether the IRS wants to make a public example out of a particular tax evader, they want to collect the money or both. Generally, the IRS prefers to just collect the taxes plus any noncriminal penalties the law permits, even though the taxpayer could be prosecuted for a criminal offense.

In criminal cases, the IRS must prove every facet of the offense and show guilt beyond a reasonable doubt. In case of fraud, the IRS has the burden of

establishing such fraud by clear and convincing evidence. A taxpayer should be acquitted if the evidence is equally consistent with innocence as with guilt.

Avoidance of taxes is not a criminal offense. Any attempt by a taxpayer to avoid, reduce, minimize or defer taxes by legitimate means is permissible. The distinction between avoidance and evasion can be a fine, but definite, line.

A taxpayer who avoids taxes does not conceal or misrepresent. The taxpayer shapes events to reduce or eliminate tax liability and, on the happening of the events, makes a complete disclosure. For example, a licensee may wish to "pull" expenses into the year that is ending to reduce taxes coming due soon. On December 30, a licensee may write a check and send it to a charitable organization to obtain a charitable contribution deduction in December. Even though the check may not be cashed by the organization until January 20, the deduction would be available in December. Or, the taxpayer may choose to purchase tax-exempt municipal bonds instead of purchasing fully taxable corporate bonds.

Evasion involves deceit, subterfuge, camouflage, concealment or an attempt to color or obscure events. For example, a licensee writes the check on December 30 but does not mail the check to the charitable organization until January 5, or the taxpayer may have written the check in January and dated it in December. Other forms of subterfuge would be knowingly reporting 200 miles for a business trip instead of the correct amount of 120 miles or taking turns in buying and deducting lunch expenses with another business acquaintance. Failing to report cash income is another form of subterfuge.

The willful attempt to evade or defeat any tax, or the willful attempt to evade or defeat the payment of any tax, constitute criminal offenses. Three elements are necessary for a criminal offense: (1) an additional tax is due and owing, (2) there is an attempt in any manner to evade or defeat any tax and (3) the attempt is willful.

The IRS must establish that, at the time the offense was committed, an additional tax was due and owing. In essence, the individual must owe more taxes than was reported. But the IRS does not have to prove evasion of the full amount alleged in the indictment. It is sufficient to show that a substantial amount of the tax was evaded, and this proof need not be measured in terms of gross or net income or by any particular percentage of the tax shown to be due and payable. It is the current policy of the IRS not to authorize assessment of any additional taxes and penalties during the time any criminal charges are pending, and to postpone any discussion or negotiation involving settlement of the <u>civil</u> liability.

The phrase "attempt in any manner" does not mean that those whose efforts are unsuccessful have not committed the crime of willful <u>attempt</u>. The crime is complete when the attempt is made, and nothing is changed by its success or failure. The criminal character of an offense lies not in the failure to file a return or in the filing of a false return but rather in the attempt to evade any tax. Thus, the term "attempt" implies some affirmative action or the

commission of some overt act. The Supreme Court has given the following illustrations of acts or conduct from which the attempt to evade or defeat any tax may be inferred: (1) keeping a double set of books, (2) making false entries, (3) alterations of invoices or documents, (4) destruction of books and records, (5) concealment of assets or covering up sources of income and (6) the handling of one's affairs to avoid making the records that are usual in transactions of the kind.

Willfulness is an essential element of proof with respect to most criminal violations investigated by special agents. This word "willful" generally means an act undertaken with a bad purpose; without justifiable excuse; or stubbornly, obstinately, perversely. The Supreme Court indicates that "willful" characterizes an act done without grounds for believing it is lawful, or conduct marked by careless disregard whether or not one has the right so to act. The most laudable motive is no defense where the act is a crime committed with knowledge of the law. For example, a taxpayer may intentionally understate income to have sufficient funds to support invalid parents. Although such motive may be admirable, the taxpayer has specifically intended to evade payment of income taxes. Willfulness is a state of mind that is difficult to prove. Circumstantial evidence frequently is used to prove willfulness. The following acts committed by taxpayers have been used by courts to prove willfulness: (1) attempting to bribe a revenue agent, (2) entering undisclosed safe-deposit boxes after having been questioned about assets, (3) making false statements, (4) withholding records during investigation and (5) influencing the testimony of a prospective witness.

Ignorance of the law is a defense against criminal penalties but is not a defense against civil penalties. Even though criminal tax evasion is difficult to prove, tax avoidance is not necessarily a financially painless alternative. Interest and possible penalties are assessed on underpayments. But at least, the <u>avoidance</u> of taxes is not a felony offense and does not carry the risk of a prison term. Thus, the <u>real</u> difference between tax evasion and tax avoidance is the possibility of a prison term and possible financial penalties in addition to any civil penalties.

CONCLUSION

Taxpayers are going to find an ever increasing portion of future income being lost in taxes--unless they know what to do and how to deal with this problem. Taxpayers often are surprised at the tremendous sums of money that the various governmental units collect each year due to no reason other than poor recordkeeping and inadequate tax planning by taxpayers. These sums could have and should have been avoided legally. The government expects what is legally due but not a dollar more. Use this booklet throughout the year to keep records more effectively. Take time to accumulate, record, summarize and retain the appropriate tax information.

Appendix 1
ATTRIBUTES OF MAJOR BUSINESS ORGANIZATIONS

	Proprietorship	General Partnership	Limited Partnership	Corporation	Subchapter S
1. Limited liability	No	No	Yes, for limited partners	Yes	Yes
2. Taxable status	progressive rates; single tax	progressive rates; single tax	progressive rates; single tax	double tax	progessive rate; single tax
3. Transferability of ownership	easy	awkward	awkward	easy	less awkward
4. Fringe benefits of owners	not deductible	not deductible	not deductible	deductible	deductible
5. Maximum federal tax rate	50%	conduit	conduit	46%, plus individual rate for dividends	conduit
6. Accumulation of earnings in entity	impossible	impossible	impossible	Yes	Yes
7. Government supervision	least	minimal	minimal	great deal	great deal
8. Length of life	limited	limited	limited	indefinite	indefinite
9. Timing of taxation	all earnings taxed at close of year	salary, interest and distributions taxed at close of year	salary, interest and distributions taxed at close of year	corporate tax at end of year; second tax during year paid	salary, dividends and interest taxed at time paid. Taxable income allocated pro rata to share-holders.
10. Management	personal	partners	general partners	officers	officers/ owners

Appendix 2

ACCELERATED COST RECOVERY TABLE

All Buildings (Except Low-Income Housing)

The applicable percentage is:

(Use the Column for the Month in the First Year the Property is Placed in Service)

If the Recovery Year is:	1	2	3	4	5	6	7	8	9	10	11	12
1	12	11	10	9	8	7	6	5	4	3	2	1
2	10	10	11	11	11	11	11	11	11	11	11	12
3	9	9	9	9	10	10	10	10	10	10	10	10
4	8	8	8	8	8	8	9	9	9	9	9	9
5	7	7	7	7	7	7	8	8	8	8	8	8
6	6	6	6	6	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	6	6	6	6	6	6	5	6	6	6	6	6
9	6	6	6	6	5	6	5	5	5	6	6	6
10	5	6	5	6	5	5	5	5	5	5	6	5
11	5	5	5	5	5	5	5	5	5	5	5	5
12	5	5	5	5	5	5	5	5	5	5	5	5
13	5	5	5	5	5	5	5	5	5	5	5	5
14	5	5	5	5	5	5	5	5	5	5	5	5
15	5	5	5	5	5	5	5	5	5	5	5	5
16	-	-	1	1	2	2	3	3	4	4	4	5

(Note: These tables do not apply for short taxable years of less than 12 months.)

Appendix 3

ACCELERATED COST RECOVERY TABLE

Low-Income Housing

The applicable percentage is:
(Use the Column for the Month in the First Year the Property is Placed in Service)

If the Recovery Year is:	1	2	3	4	5	6	7	8	9	10	11	12
1	13	12	11	10	9	8	7	6	4	3	2	1
2	12	12	12	12	12	12	12	13	13	13	13	13
3	10	10	10	10	11	11	11	11	11	11	11	11
4	9	9	9	9	9	9	9	9	10	10	10	10
5	8	8	8	8	8	8	8	8	8	8	8	9
6	7	7	7	7	7	7	7	7	7	7	7	7
7	6	6	6	6	6	6	6	6	6	6	6	6
8	5	5	5	5	5	5	5	5	5	5	6	6
9	5	5	5	5	5	5	5	5	5	5	5	5
10	5	5	5	5	5	5	5	5	5	5	5	5
11	4	5	5	5	5	5	5	5	5	5	5	5
12	4	4	4	5	4	5	5	5	5	5	5	5
13	4	4	4	4	4	4	5	4	5	5	5	5
14	4	4	4	4	4	4	4	4	4	5	4	4
15	4	4	4	4	4	4	4	4	4	4	4	4
16	–	–	1	1	2	2	2	3	3	3	4	4

(Note: These tables do not apply for short taxable years of less than 12 months.)

Appendix 4

Forms

MILEAGE LOG

Description of vehicle ____________________

Number of months vehicle used in business ____________

Beginning odometer mileage ____________

Ending odometer mileage ____________

Insurance ____________

Taxes ____________

Tag & License Fees ____________

Interest ____________

Date	Gasoline, Oil, Lubrication	Repairs	Tires, Supplies	Miscellaneous	Parking Fees, Tolls

TRAVEL (AWAY FROM HOME) AND ENTERTAINMENT EXPENSE DIARY*

Date/ Place	Transportation	Lodging	Meals	Entertainment	Other Expenses	Business Purposes/ Business Relationship

* Keep receipts for lodging and any other expenditures of $25 or more.

HOME-OFFICE EXPENSE DIARY*

Number of rooms in house/apartment ________________
Number of rooms used for business ________________
Total square footage ________________
Square footage used for business ________________

Date	Electrical	Gas, Oil	Telephone	Interest	Taxes	Repairs, Maintenance	Rent	Other	Comments

* Keep receipts and do not forget to calculate any depreciation on house, including major home repairs such as new roof or painting.

MISCELLANEOUS EXPENSE DIARY

Date	Professional Dues	Business Publications	Supplies/ Tools	Business Gifts	Advertising Expense	Accounting Legal	Uniform Work Clothes	Other (Specify)

FILING SCHEDULE

1983	1984	
January 17	January 17	4th installment payment of individual estimated taxes for prior year.
February 1	February 1	Employer must give employees Form 1099 or 1087 indicating compensation totals.
March 15	March 15	Corporate Form 1120 and Subchapter S Form 1120-S are due for calendar year taxpayers.
March 16	March 16	Subchapter S election Form 2553 is due.
April 15	April 16	. Individual Form 1040 is due. . File a declaration of estimated tax and pay 1st installment of individual tax. . Calendar year partnership Form 1065 is due. . Corporate deposit of 1st installment of estimated income tax for current year.
June 15	June 15	. If individual filed automatic two-month extension to file income tax return for prior year, Form 1040 due. . 2nd installment of individual's estimated taxes. . If corporation filed automatic three-month extension, Form 1120 due. . Corporate deposit of 2nd installment of estimated income taxes.
September 15	September 17	. 3rd installment of individual estimated taxes due. . 3rd installment of corporate estimated income tax due.
December 15	December 17	. 4th installment of corporate estimated income taxes due.

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CITY ______________________ STATE ______________________

Present principal business ______________________

To what professional organization do you belong? ______________________

____

What magazines/periodicals do you read most regularly to stay abreast of real estate topics?

(1) ______________ (2) ______________

(3) ______________ (4) ______________

To what degree did this publication or audio visual meet your needs?

Too technical ______________
Not technical enough ______________
Too brief ______________
Too detailed ______________
Other comments ______________

____

What information/topics/issues related to real estate do you need to know more about?

____

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