8 Tax Mistakes

Real Estate Agents

Make That Cost Them $1000s

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Real estate agents have a lot of planning opportunities when it comes to taxes, and they also have a lot to lose if they play their cards wrong. I should know, I am a CPA and also a Real Estate Agent.

Below I have listed 8 tax mistakes I see real estate agents make regarding taxes. If you were like me and a W2 employee before jumping in to real estate, it's a different ball-game. You have to be proactive to maximize your tax benefits.

1. Most agents aren't taking advantage of the new tax law changes.

The new tax law makes some sweeping changes for business owners such as real estate agents. And yes, real estate agents are business owners.

One of the biggest tax law changes helping business owners is the deduction on 20% of your net income from "qualified business income."

"Qualified business income" includes income you make that "passes through" to your individual return. For most people, this is any income they don't make in a C corporation.

Here's an example.

Let's say you're a real estate agent, and these are your numbers for 2020:

- Revenue "R" = $400,000
- Expenses "E" = $150,000
- R – E = net income = $250,000

Before the change, you would pay tax on that full $250,000 of income.

Now, however, you get to deduct 20% of your net income (what you actually earned) when calculating your taxable income (what you're taxed on)!

So in the example above, 20% of $250,000 gives you a $50,000 pass-through deduction, so you would only have to pay tax on $200,000 of income. Of course, its not that simple.

So how much in real savings are we talking about?

How much will you save in taxes? Well, that depends on your tax bracket.

$250,000 in income for a married couple filing jointly places you in the 24% tax bracket.

The math is slightly more complicated than this, but the idea is that the $50,000 pass-through deduction in the example above times your 24% marginal tax rate is $12,000, meaning that you will save nearly $12,000 in taxes just from knowing about this deduction and taking properly!

It gets complicated.

However, if you make more than $163,300 as a single filer or $326,600 as a married filer, your ability to take this deduction may be limited if not eliminated.

And if you make more than these threshold amounts, it *might* make sense for you to be taxed as a corporation, depending on how much of your business earnings you plan to use to fund your lifestyle and how much you plan to reinvest into the business.

There are a few other ins-and-outs to this pass-through deduction, so be sure to check with your CPA or tax advisor.

2. Most agents aren't maximizing their auto expenses.

Most real estate agents simply take the standard mileage deduction for the miles they put on their car in their business. But it may not be the most beneficial way to maximize their car-related expenses.

Two Methods for Calculating Automobile Deductions

There are two methods that business owners can use to deduct automobile-related expenses.

One is the standard mileage deduction, where you get a deduction ($0.575 per mile in 2020) for every mile you put on your car for business purposes.

The other method is the actual expense method. In this method you figure out how much of your vehicle was used for business purposes (based on mileage) and then prorate your car expenses such as gas, insurance, and repairs between business and personal and deduct the business piece.

Which to Use?

So which one should you use? Well, it depends on your individual situation, but here's is some advice.

If your car is relatively new, it probably makes more sense to use the actual expense method, writing off actual automobile expenses you incur during the year (to the intent your vehicle is used for business) and depreciating the business use portion of your car as well.

But if your car is older, it may make more sense to simply use the standard mileage method.

However, every agent's case is different, especially depending on how much they use the car for business vs. personal use, so it really takes an analysis of each method to know which method will result in the greatest deduction. The analysis and your ability to keep records are key.

Track Your Mileage!

However, whichever method you use, it is essential that you track your mileage.

If you deduct automobile-related expenses, the IRS actually ***requires*** that you keep a mileage log that records:

- Your mileage
- The date of your drive
- The place(s) you drove for business
- The business purpose of your trip

The IRS also makes you report the total number of miles you drove during the year not only for business but also the commuting miles you drove driving to a W-2 job and the personal miles you drove for non-business, non-employment related purposes.

Use an App.

Back in the day, logging your mileage log every time you drove your car for business was a pain.

But now there are easy-to-use apps that take the stress out of logging mileage. I use QuickBooks Self Employed that automatically recognizes when I am traveling in my car and records the mileage. After every week, I categorize the trips as business or personal. Another Real Estate Agent I know uses an app called MileIQ that does the something similar.

3. Most agents aren’t maximizing their home office deduction.

If you use a part of your home or apartment exclusively and regularly for the administration and/or management of your business, you’re entitled to the home office deduction!

A few years ago, folks used to say that the home office deduction was an audit red flag, but that’s simply not the case anymore.

If you document the use of your home office correctly, you can deduct a portion of your rent (if you rent), your mortgage interest (if you own), utilities, repair bills, insurance, and more!

Oh yeah, and you can even take a depreciation deduction on a portion of your home (if you own)!

Key Point: if you have a corporation set up, you will have to set up an accountable plan to take the equivalent of the home office deduction.

4. Most agents are calculating depreciation incorrectly.

The two deductions above — automobile and home office — often involve a depreciation calculation.

Getting these calculations right is extremely important because the IRS will tax you on your gain as though you calculated depreciation correctly, even if you don’t.

What Is Depreciation?

For most expenses you have as a real estate agent, you can deduct their cost in the tax year in which you incurred the expense. Examples of this are your advertising expenses, marketing, education/training, license fees, office supplies, phone bills or desk fees, etc.

Other costs, however, cannot be deducted in the same tax year as the cost was incurred. These costs have to be "capitalized" to the basis of your property, and you get a deduction for a little bit of the cost every year. This is the depreciation deduction.

Here are some tips on calculating depreciation correctly.

Depreciating Property

If you're taking the home office deduction, and you own your home, you are entitled to depreciate a portion of your house.

But there are some things to remember when depreciating a piece of property, be it a rental property or a portion of your home due to the home office deduction.

Whenever you purchase a property, the tax code says that you have to allocate what you paid for it (your "basis") between land and building.

The difference is that you can take a depreciation deduction on the basis allocated to building but not for the basis allocated to land. Land is not depreciable.

This being the case, most people want to allocate as much as possible to building and as little as possible to land so that they can get more depreciation deductions.

Now, the everyday way to allocate between land and building is to use the county assessor's determination of land vs. improvements for property tax purposes.

However, there are other reasonable methods that can be employed in determining the land/building split, such as based on replacement value of your building (with the difference between your total basis and the replacement value being allocated to land).

The point is that you must allocate some reasonable amount to land, or you just may find the taxing authorities knocking on your door.

Depreciating Cars

You can depreciate what you paid for a car to the extent you use it for business.

So if you purchased a car for $20,000, and you use it 80% of the time for business (based on mileage), you can depreciate $16,000 of it over time.

That $16,000 is your depreciable cost basis in your car.

However — and this is what I see people miss a lot — if your car was originally used strictly for personal use, and then you started using it in your business, your cost basis is the lower of the amount calculated above or the car's business use percentage times the fair market value of the car at the time you started using it in your business.)

5. Most agents aren't keeping good records of their expenses.

This is not solely a problem for agents, but I have done the returns of agents who have missed out on literally thousands of dollars worth of deductions simply because they weren't keeping good records.

This can be as simple as having a separate business bank and credit card account through which you pay expenses for your business.

Having all of your expenses neatly organized in front of you to determine which are deductible and to what extent is the first step in maximizing your tax deductions.

Here are some tips on keeping good business records:

Invest in a good bookkeeping system.

I'm not saying that you have to run out and buy some full-blown enterprise software system.

For newer agents, "a good bookkeeping system" may be as simple as an Excel spreadsheet where you categories your expenses every month.

It could be investing in decently-priced bookkeeping software such as Quickbooks Self-Employed mentioned earlier.

And of course, it could mean paying someone else to keep your books for you.

Just find something that works for you.

Hang on to your receipts.

Some taxpayers are under the impression that bank or credit card statements are enough in an audit.

They're not!!!!

The IRS will want to see receipts to see exactly what your money was spent on.

If it's a client meal, that should even include a quick note about who you met!

And thanks to technology, electronic receipts are fine. Just snap a pictures of your receipt with your smartphone every time you get one and then upload your receipts to a folder on your computer or to an app like QuickBooks or Evernote.

Use your camera phone often.

Receipts aren't the only things you should be taking pictures of.

Remember, the more documentation you have to support a business expense, the better.

For example, when you're on the go, it doesn't hurt to snap a quick picture of where you went (e.g., an open house or a client meeting) to collaborate the claims you make on your mileage log (see above).

6. Most agents aren't hiring their kids.

If you have children who are old enough to help you with various tasks in your business (say around age 6 or 7), put them to work and pay them!

The tax benefits for doing this are pretty awesome for both you and your kids.

Be Honest With What Your Kids Are Doing.

Keep good records of what exactly the kids are doing (filing, shredding, etc.).

Please make sure their salary is reasonable, or you're asking for a world of hurt from the IRS.

For the most part, your children are unskilled laborers, and they should probably be paid about minimum wage.

Of course, standard pay raises are OK as the years go by, and perhaps even paying quite a bit more than minimum wage is acceptable for teenagers with some kind of skills under their belt (such as web coding or social media if they work on your website and your brand).

You Can Pay Them Up to $12,400 (2020) Without Them Paying Tax.

Everybody, even dependent children, are entitled to the standard deduction (for 2020 taxpayers with single filing status) of $12,400.

This means that you can pay each child $12,400, and they won't have to pay a penny of tax on it!

Meanwhile, your business gets a $12,400 deduction. Boom.

Now this doesn't mean that you can't pay them more than $12,400.

You can. It's just that they will start paying tax on income over $12,400, though it will be in the low tax brackets, so this still may make sense.

They Can Set Up Retirement Accounts Too!

Here's another cool thing about paying your kids. Now that they have earned income, they can contribute to a traditional IRA, a Roth IRA, or a college savings account.

So not only does your business get a deduction and your kids make money, but they also get to start growing wealth tax-deferred or tax-free.

Note that if they choose to set up a traditional IRA account (which I would not necessarily recommend as a Roth IRA is likely more beneficial to them at this point), you can pay them up to $18,400 without them paying tax ($12,400 standard deduction + $6,000 traditional IRA contribution).

Children 17 and Younger

An awesome thing about paying your minor children is that you do not have to pay payroll taxes on their wages!

So you do not have to file W-2s or 1099s for kids under 18.

The trick is that you can't pay them out of your S corporation or you'll have to withholding payroll taxes and issue them a W-2.

So here's the strategy: get a DBA and set up a sole proprietorship (Schedule C), have your S corporation pay management fees to this sole proprietorship, and pay your kids out of the sole proprietorship. Boom.

Children 18 and Older

However, once your kids turn 18, you have to start issuing them either 1099s or W-2s.

But this isn’t a bad thing necessarily because now they can show some income on their tax returns, which can help them, say, buy a rental property in their early 20s.

7. Most agents aren’t doing health insurance right.

If you’re self-employed, chances are you’re paying for your health insurance entirely out-of-pocket.

And this hurts.

Well, you can alleviate the pain a bit by paying your health insurance premiums through your business.

Jump through the hoops, and you will save big.

Now, if you have an entity set up, it’s a bit of a process in order to get the health insurance deduction.

But it is worth it in the end when you save thousands of dollars in taxes as a result.

Also, make sure that the health insurance premiums your entity paid on your behalf is indicated on your W-2 or you cannot take the deduction!

If you’re young and healthy, consider a Health Savings Account (HSA).

An HSA is not a use it or lose it plan (common misconception) like the Flexible Spending Account (FSA).

Think of HSAs like a combination of a traditional and a Roth IRA.

You get a tax deduction up-front when you put money in (like a traditional IRA).

And you also get to grow your wealth inside the account tax-free and take it out tax-free (like a Roth IRA) if when you take money out it's used to pay for qualifying medical expenses.

Talk about the best of both worlds!

Oh, and by the way, you can self-direct your HSA to invest in real estate.

Don't have enough money in your HSA to put a down payment on a property? Well, you can invest with others' HSAs, pooling the funds in an LLC, to buy a property where you each share the rents and expenses pro rata.

And when you sell the property? Tax-free. Boom.

Oops, you died? Your HSA goes to your spouse's HSA, tax-free.

If you're not so healthy, also consider a Health Reimbursement Arrangement (HRA).

Like the HSA, the HRA is is not a lose it or lose it plan. It is a reimbursement arrangement where you can hire yourself or your spouse to have your healthcare paid for.

An HRA allows you to write off an additional $10,000 on top of an HSA for any out-of-pocket medical, but you have to have a plan document that's set up by the end of the year and do your healthcare reimbursement before the end of the year.

If you don't do the reimbursement by year-end, you don't get the write-off. This makes sense for folks with high medical bills.

8. Most agents aren't stashing away money in tax-favored accounts.

From a tax perspective, one of the greatest parts of being a small business owner is the retirement account options available to you.

Unfortunately most real estate agents who come to me typically just have two retirement accounts, if any:

- A 401(k) from a former employer, and
- A traditional or Roth IRA

I mean, that's a good start, but as a business owner, there is so much more you can do to save on taxes this year and build tax-free (or tax-deferred) wealth in the long run.

If you're enjoying some success as an agent, a $5,500 annual contribution to your IRA isn't going to cut it. You need bigger deductions for retirement account contributions if want to speed up wealthbuilding.

Simplified Employe Pension (SEP) Plan

The SEP is something of an "old-school" retirement plan for the self-employed. If you are sole proprietorship, this is your only option really.

Here's how a SEP works.

You can contribute up to 25% of your profit (if sole proprietor) or 25% of wages (if an S corporation) into a SEP, up to $57,000 a year (2020).

And you have up until the extended due date of your personal return (if you're a sole proprietor) or your multi-member LLC's or corporation's return to contribute to make your SEP contribution.

So if you're a sole proprietor, you have until October 15 of the following year to make your SEP contribution for the previous year!

Now the SEP's all well and good, but there is actually an option that works better for most people. It's called the Solo 401(k).

Solo 401(k)

A Solo 401(k) operates similarly to a SEP, but with some positive modifications.

You are still capped at $57,000 a year (or $63,500 if you are over the age of 50 in 2020), but you can contribute more to a Solo 401(k) than to a SEP at the same W-2 level.

Let's say your business exists as an S corporation that pays you a $100,000 salary.

In a SEP, you can only contribute $25,000 (25% of wage income).

However, in a Solo 401(k), you can contribute up to $19,500 on your first $19,500 of W-2 wage and then 25% of total wage income.

So if your W-2 wage is $100,000, you can contribute $19,500 + $25,000 = $43,000 to your Solo 401(k)! Compare that to only $25,000 that you could contribute to your SEP!

There are other perks of the Solo 401(k), such as the fact that you can self-administer your 401(k) and take loans out of it up to $50,000.

Also, if you invest in leveraged real estate through your Solo 401(k), you will not be subject to the dreaded unrelated business income tax. If you invest in leveraged real estate through a SEP, you will be subject to this tax.

However, unlike a SEP, you do have to get it set up by year-end for the year that you want the benefit.

Retirement Account for Non-Working Spouse

Here's a cool strategy you can use with a 401(k) if you have a non-working spouse.

Let's say you're a full-time real estate agent with an S corporation and payroll.

Hire your spouse for some basic work during the year, paying them, say, $20,000.

Your spouse can then make a contribution up to $19,500 (2020) into their 401(k) and then your business as their employer can put in a 25% match.

So your spouse's W-2 ends up being $0, they get $20,000 in their 401(k) plus a $5,000 match, and your business has a $25,000 write-off.

And yes, your spouse can self-direct their IRA so they can go invest in real estate.

You Need the Right Plan in Place

More than having your taxes prepared at the end of the year, having a tax plan in place specifically designed for your situation, is where you can really start saving on your tax bill.

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