

Table of Contents

<i>Foreword</i>	ix	
<i>Discussion</i>		
1. Discussion of Tax Minimization		
Investment Strategy	1	
Tactics.....	6	
Active Investments	9	
One-Year Depreciation.....	10	
Research Credit.....	12	
Short Term Rentals.....	18	
Defense of the Tax Return.....	19	
Limitations of Passive Investments	23	
2. Strategic Issues		
Overview of New Tax Laws.....	29	
Tax Incentives for Investment	30	
Asset Protection.....	37	
3. Discussion of Relevant Law		
Joint Ownership.....	43	
Depreciation.....	46	
Rehabilitation Tax Credit	54	
Business Deductions.....	57	
Limits imposed by the Tax Cuts and Jobs Act, 2017	59	
<i>Exhibits</i>		
A. Selected Tax Returns		
Discussion.....	63	
2017, High wages, zero tax, before 2017 Tax Act	65	
2018, High wages, moderate tax, after 2017 Tax Act.....	97	
2018, High gain, zero tax, after 2017 Tax Act	127	
B. Economic Factors: Inflation, House Prices, Life Expectancy.....		179
<i>References</i>		195
<i>Qualifications of the Author</i>.....		197

Congressional Design of Tax and Banking Laws

For Congressional tax planning, the target is an intentional shift to high rates for income tax and estate tax for taxpayers with extreme wealth and extremely high income. The higher marginal propensity to consume by persons with low income results in a substantial economic growth.

Wealth Tax. It is foreseeable that new tax statutes will be designed to increase income taxes and estate taxes for extremely wealthy taxpayers. New forms of taxation, such as excise taxes may be a practical necessity.

Global warming. It is not reasonably disputed that current trends in energy sources and use will result in unacceptable economic damages. The sea level rise by 20 feet is expected to result from a 2 degree increase in global temperature. The uncertainty is whether the 20 feet rise will occur in 20 years or 100 years, depending on major changes promptly required.

Energy Issues. Major tax credits and investment incentives are now required to redesign energy sources and energy use. Clearly, increased tax incentives are required to promote electric vehicles and increased use of solar power, wind power, and high technology approaches to new fuels, such as hydrogen peroxide derived from sea water through algae.

Foreign Trade and Tariffs. It is easily proven that efficiency and national wealth results from minimal obstacles to international trade. Clearly, the recent focus on increases in tariffs is wrong, terribly wrong.

Aging Population. For many developed nations, population projections demonstrate a shift to more persons over age 65, and fewer persons in the labor force, age 20 through 64. Recent changes in the measurement of inflation will result in social security payments that do not keep pace with the cost of living.

Immigration. The United States should welcome immigration, to increase the number of experienced workers needed in farming, construction, and maintenance. Training and education can result in skilled employees to perform high technology tasks. The immigrants can provide the needed balance in the age distribution of our labor force.

1. Discussion of Tax Minimization

Investment Strategy

It is feasible for a prudent investor to reduce federal income tax and even to pay zero income tax. A taxpayer has the fundamental right to minimize taxes. As stated by Judge Learned Hand:

... nobody owes any public duty to pay more than the law demands, 159 F2d 848, 851.

... Anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes. 69 F2d 809, 810, *aff'd* 293 U.S. 465.

... [The] legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether to avoid them, by means which the law permits, cannot be doubted. 293 U.S. 465, 469.

Relevant tax law allows tax minimization. There are three primary rules:

Report all income. Failure to disclose all income is a felony, 26 USC §7206(5)(B).

Keep good records. Detailed and accurate records are a practical necessity. Willful failure to keep adequate records is a felony, 26 USC §7203.

Invest in your small business and real property. A business form that allows pass-through of tax characteristics from your small business to your personal tax return is essential. The business should be active, meaning that your personal involvement and executive decisions are required. By contrast, as a mere employee, you will be required to pay an uncomfortably high income tax.

Special features of investments in real property. Real property offers several characteristics which allow high yield with minimum income tax. The following are several examples of the special features of real property assets. Because the taxable limits for estate and gift tax is very high, it is feasible to transfer partial ownership of real property to the next generation by way of gift. This way, the appreciation in value vests with the next generation. Although there are many forms of property ownership, title to real property is easily established as Joint Tenants. Joint tenant ownership has advantages of simplicity and low cost. When one of the joint tenants is deceased, the survivors get a stepped-up basis which results in zero gain on sale, and the capital gains tax is forever lost from the taxing system, 26 USC §1014(a)(1).

There are several methods to minimize tax on the increase of value for real property. One method is to keep the property within the family for many years. There is no tax on gain until the property is sold. You purchase a single family residence. After the value has increased by \$500,000, you sell the property to a related party (son, daughter, grandchildren) for market value, 26 USC §482. There is no tax on the \$500,000 gain because the parents lived at the property during two of the past five years, 26 USC §121.

To minimize tax on the gain, the transaction can be designed as an *installment sale*, so that at least part of the purchase payments are scheduled after the year of sale, 26 USC §453. This way, the gain may be spread over several future years, so that other future deductions can offset the taxable gain. When installment sale is to a related party, the related party must hold the property for two years after their purchase, 26 USC §453(e)(2)(A).

Joint Family Ownership. Significantly, when the parents and adult children jointly own the real property assets, the allocation of depreciation and tax credits among owners is established by the agreement of the owners. Dominant case decisions and relevant regulations hold that the joint ownership of real property can be treated as a small family partnership without a separate partnership return, provided that the details of the allocations are disclosed to prevent double counting.

Tactics

Many of the tax incentives are designed to reward a small business and active investors, as contrasted to passive investors. *Active* investments include operation of a small business or rental of real property in which the investor takes an active role in the management of the business. By contrast, *passive* investments include securities, partnership shares, and real property rental operations in which the investor does not take an active role in decisions and operation of the business. Many prudent investors focus on operation of an active sole proprietorship business combined with active operation of a real property rental business. The following are specific examples of tax provisions which are used by prudent investors to significantly cut income tax, and to allow high yield after tax.

1. Qualify for one-year depreciation for interior rehabilitation for your short-term rental real property, 26 USC §179(f)(1); 26 USC §168(e)(6).
2. Purchase a new residence and then sell your prior residence within 3 years after the purchase, with three years of appreciation on two properties and with no tax on the capital gain of up to \$500,000, 26 USC §121.
3. Earn *research credit* by investing in research supplies and contract labor to develop new software, 26 USC §41(d)(4)(E)(i).
4. Earn *energy tax credit* by purchasing an electric car 26 USC §30D(b) and by installing solar power for your house, and 26 USC 25D(g).

Active investments, such as operating a sole proprietorship or rental of real property can result in major deductions and tax credits. One-year depreciation is allowed for purchases of new equipment, new vehicles, and for interior rehabilitation for non-residential real property. Significantly, *residential* property which is used for short-term rentals is classified as *non-residential* real property. Tax credits result from increased research expenditures, outlays for disability access, and purchases of energy efficient equipment, such as electric vehicles or solar power.

Active Investments

To reduce income tax, some highly-paid employees rely on *active* investments, such as a sole proprietorship and rental of property. The business operation may include joint ownership of rental real property, as a small family partnership.

Short-Term Rentals. For maximum gross income, and one-year depreciation of interior rehabilitation, short-term rental of a furnished residence has significant advantages. Based on hearings and responses from property owners, the city council members for several large cities have determined that short-term rentals are allowed. For other cities, new state and city ordinances prevent or limit rentals of 30 days or less.⁴ The results of future litigation may establish that such city and state restrictions are repugnant to the U.S. Constitution⁵ and are therefore void *ab initio*, from the start.⁶ Current California state codes prevent unreasonable restriction of rental of an accessory dwelling unit.⁷ Typical restrictions against short-term rentals do not apply to rental terms of 32 days or more.

⁴ The new City of Los Angeles Short Term Rental Ordinance became effective on July 1, 2019.
[https://planning.lacity.org/ordinances/docs/homesharing/adopted/Final Ordinance.pdf](https://planning.lacity.org/ordinances/docs/homesharing/adopted/Final%20Ordinance.pdf)

⁵ See: *City of Los Angeles v. Patel*, 576 U.S. ____, 1995, 135 S.Ct. 2443.
https://www.supremecourt.gov/opinions/14pdf/13-1175_k537.pdf
<https://www.scotusblog.com/case-files/cases/city-of-los-angeles-v-patel/>

⁶ See: Richard R.Sylvester, *The King Takes Your Castle, City Laws that Restrict your property rights*. San Diego: Academia Publishing Co., 2015.
https://www.amazon.com/King-Takes-Your-Castle-Restrict/dp/0932010040/ref=sr_1_1?keywords=Books:+Sylvester,+the+king+take+your+castle&qid=1563025082&s=gateway&sr=8-1

⁷ See: California Government Code, Section 65852.150
(Added by Stats. 1994, Ch. 580, Sec. 1. Effective January 1, 1995.)
http://leginfo.legislature.ca.gov/faces/codes_displaySection.xhtml?sectionNum=65852.150.&lawCode=GOV

One-Year Depreciation, Section 179

One-Year Depreciation. Under existing laws, it is feasible to use one-year depreciation to eliminate most of a taxpayer's entire income tax obligation. Then, the remainder of income tax can be cancelled with tax credits, resulting in zero income tax. The expenditures must be in qualifying categories, and within specified limits. For 2018, the taxpayer may elect to deduct up to **\$520,000** in capital expenditures under section 179 property placed in service in 2018, 26 USC §179(f). For 2017, the maximum one-year deduction for depreciation was \$210,000. For qualified property, deduction of the cost or other basis may be a single year, as authorized by 26 USC §§179(a), 179(b)(1). The election to expense in one year is made on Form 4562.

By definition, property used for short-term rentals is classified as non-residential real property. The following types of assets are eligible for the one-year expense election:

1. Property specified in 26 USC §1245 is depreciable personal property, which excludes buildings. Personal property includes equipment, vehicles, and fixtures. Section 1245 property includes research or storage facilities, excluding buildings, 26 USC §1245(a)(3). Gain on Section 1245 property is treated as ordinary income, not capital gain, 26 USC §1245(a).
2. Computer software, off-the-shelf. 26 USC §179(d)(1).
3. Qualified improvements to real property, specified as interior improvements for nonresidential real property, but excluding enlargement, elevators, or internal structural framework, 26 USC §168(e)(6), 26 USC 26 §179(f)(1).
4. Improvements to nonresidential real property: roofs, heating, ventilation, and air conditioning, 26 USC §179(f)(2).

The following are the primary limits for a Section 179 deduction:

- (a) \$510,000 annual expense for qualified property in placed service in 2017, and \$520,000 for 2018, 26 USC §179.

- (b) Investment ceiling of \$2,030,000 for 2017, and \$2,070,000 for 2018, 26 USC §179(b)(2)
- (c) The deduction amount is limited to the amount of taxable income from the taxpayer's business operations. Employees are deemed engaged in the conduct of their business of employment, 26 CFR §1.179-2(c)(6)(iv).

The amount of taxable income from active business operations includes employee wages, profit from Schedule C, and profit from Schedule E. By contrast, passive income, such as securities investments or capital gains are not included. Employees are deemed engaged in the conduct of their business of employment, 26 CFR §1.179-2(c)(6)(iv). The one-year depreciation amount, 26 USC §179, is reduced by 10% due to rehabilitation tax credit, 26 USC §47.

For Section 179, the total taxable income is computed without regard to the following deductions from income:

- The cost of the qualified expense property
- The deduction for one-half of the self-employment tax
- Net operating loss carrybacks or carry-forward
- Passive activity rules, 26 USC §179(b)(3), 26 CFR §1.179-2(c)(1).

Short Term Rentals

Short-Term Rentals. There are significant advantages for operation of residential rental property as a short-term rental, instead of reliance on a long-term lease. Vacancy is a major problem for the owner of rental property. The global use of internet booking firms, such as Airbnb, allow rapid and efficient booking for luxury rental property. Because the prime locations and quality of the short term rentals are designed for travelers who can afford the best, the short term rentals provide a quiet and superior alternative to a hotel. For the property owner, the monthly gross income may be two or three times the market rate for an unfurnished residence. It is noted that city rent control restrictions are typically applicable only to multiple units, not to single family residences.

The obligation of the city to provide low-income housing can be funded with the 10 to 14 percent occupancy tax that is paid to the city by both hotels and short-term rentals. The high quality required for short-term rentals results in substantial investment for rehabilitation, which increases the market value of property in the neighborhood. Although the hotel lobby has attempted to influence city, county, and state governments to restrict or eliminate short-term rentals, the significant benefits to the local economy, the city budget, and to the owner of the residential property outweigh the concerns of local hotels, who serve a different market.

Significantly, the business of short-term rental for residential property is deemed to be active investment, not a passive investment, 26 USC §50(b)(2)(B). The building used for short-term rental is classified as non-residential, with depreciation life of 39 years. Although rehabilitation credits are not allowed for property used for lodging, 26 USC §50(b)(2), for residential property is used for short-term rental, the property is not classified as property used for lodging, 26 USC §168(e)(1)(A)(ii)(1).

2. Strategic Issues

Overview of New Tax Laws

In general, the 2017 Tax Act¹ primarily benefits taxpayers at the top tax bracket, but with a substantial increase in tax paid by professionals with top tier income. Through a major reduction in income tax rates at the high end, plus a major increase in exemptions for estate and gift tax, the 2017 Tax Act has created an increase in the national debt, which will cause future tax Acts to correct these temporary federal budget distortions. Although the new provision 26 USC §199A allows a deduction of 20% of sole proprietorship profit, this section does not help a company with losses. Although section 199A helps some taxpayers, such as an investment in a Real Estate Investment Trust (REIT), most taxpayers have no benefit from parts of the 2017 Tax Act. The existing major tax benefits result from the 2015 Act, signed by then-president Obama.

It is clear that the 2017 tax law fails to provide meaningful tax advantages for anyone below the billionaire class. In error, the new tax code eliminated provisions that reward investments in non-historical residential rehabilitation. In error, the new tax code eliminated Schedule A deductions for sales tax and property tax, and the employee office at home deduction. After 2020, prudent investors should anticipate a paradigm shift in future tax amounts collected at the high ends of wealth and income. In the meantime, major income tax savings are still possible based on the tax statute signed in 2015.² In summary, the primary focus for tax minimization should remain on one-year depreciation, energy tax credits, and investments that grow in value faster than inflation.

¹ The *Tax Cuts and Jobs Act*, Pub. L. 115-97, signed Dec. 22, 2017, <https://www.congress.gov/115/plaws/publ97/PLAW-115publ97.pdf>

² *Protecting Americans From Tax Hikes Act of 2015* (PATH Act), Div. Q of the Consolidated Appropriations Act, 2016, Pub. L. No. 114-113, 129 Stat. 2242 (Dec. 18, 2015). <https://www.govinfo.gov/content/pkg/PLAW-114publ113/pdf/PLAW-114publ113.pdf>

Background information is necessary to understand the complexities of relevant federal law. Several clearly written comprehensive summaries are available.⁶ For major transactions, such as real property purchases and sales, it is a practical necessity to review the relevant code sections and the dominant court decisions. Many prudent investors plan their expenditures a year in advance, based on the applicable tax law.

Stepped-up Basis. The basis of inherited property is stepped-up to the market value as of the date of death, 26 USC §1014. *Basis* is defined as the original cost less depreciation, plus capital expenditures. *Stepped-up basis* ignores the prior cost, depreciation, and expenditures, and simply recognizes the *market value* of the property on the date of death as the basis. This way, there is no taxable gain if the property is sold promptly after the date of death.

When the property title is held as Joint Tenants, probate is eliminated, and the partial interest of the decedent transfers at the instant before death to the remaining living owners, with a stepped-up basis. Then, if the recipient of property from a decedent promptly sells the property, there is no capital gain tax because the amount received does not exceed the new basis. For example:

Market value at date of death, 2019	\$ 1,400,000
Basis of property, original cost, 1990	<u>200,000</u>
Capital gain if sold before death	\$ 1,200,000
Stepped-up basis, to market value, 2019	\$ 1,400,000
Capital gain on sale, for recipient owner, 2019	0

⁶ *Federal Tax Handbook, 2019*. Hoboken , N.J.: Thomson Reuters, 2019.

<https://store.tax.thomsonreuters.com/accounting/Tax/Checkpoint-Federal-Tax-Handbook/p/100200595>.

For in-depth information, see: *Federal Tax Coordinator, 2nd*, 2019, 45 volumes.

<https://store.tax.thomsonreuters.com/accounting/Tax/Federal-Tax-Coordinator/p/100200657> volumes. Hoboken , N.J.: Thomson Reuters, 2019.