Real estate investments: king of tax shelters

finances and you

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Real estate tax shelters — often called the king of tax shelters — offer three major economic advantages.

First, leverage enables you to buy more property for less cash. Leverage is the use of borrowed money to increase the size of investment.

Second, appreciation in value during inflationary times provides an inflation hedge.

Third, real estate enjoys a high degree of economic stability because of the predictability of costs and revenues in conservative real estate investment.

In addition, real estate offers many important tax advantages. Two of these are discussed below.

Depreciation. Intially, because the partnership is engaged in constructing, developing and operating a real estate project as a business, the IRS allows the buildings to be depreciated over their useful life.

More importantly, the partnership can depreciate all real estate properties even though a significant portion of them was bought with borrowed money. When the properties are sold, the partnership pays long-term capital gains taxes (as opposed to ordinary income taxes).

The huge advantage that real estate has over other tax shelters is that even depreciation (called straight-line) is not taxed as ordinary income (called recapture). That is, in real estate tax shelters, ordinary income is converted into long-term capital gains.

At Risk Rules. In other tax shelters, the deductions an investor might claim are limited to his actual or promised investment in the deal. However, in real estate, this limitation does not apply.

For instance, you may invest $10,000 in a real estate tax shelter and receive, say, $30,000 in deductions without having to put up the additional $20,000 into the deal.

Oil and gas tax shelters

The investor puts up money to pay for the drilling of wells and, in return, receives 70-90 percent tax deductions (called intangible drilling costs) in the year of investment plus a share of any oil produced. The tax loses flow through to the investors, and the investors are not personally liable if the deal fails.

The power of an oil and gas venture comes about when a well produces oil or gas. In this case, 70-90 percent of its cost is deducted as a loss in the initial year, and when the producing well begins to deliver income from oil and gas, 15 percent of this gross income may also be deducted. This is called depreciation allowance.

These two tax benefits namely, early deductibility of costs and depletion allowance on income, help oil and gas ventures work for two investment results.

First, there is the chance of creating a potentially *substantial asset generating a cash flow that is* largely available.

Second, there is the chance to derive income from that asset over a number of years, with the additional possibility of selling the asset at long-term capital gain tax rates.

In evaluating oil programs, at least the following criteria should be examined:

1) The record;

2) financial strength of the general partner;

3) diversification of wealth;

4) the sharing arrangement between the general partner and limited partners;

5) the program size;

6) the drilling philosophy;

7) overall subjective evaluation of the limited partnership.

Equipment leasing

In an equipment-leasing tax shelter, the price of equipment exceeds the cash invested, and the cost of borrowing additional money required — sometimes up to 80 percent of the total — becomes a deduction.

In addition, the equipment usually is depreciated on an accelerated basis, and these write-offs are passed through to the limited partners. For regular corporate investors, the investment tax credit also is available.

The key to the success of an equipment-leasing venture is the residual value of the equipment at the end of the lease.

Cattle tax shelters

An investor simply buys some cattle to be fed in a feed lot, paying the operator for the feed and also a fee. Then the operator buys the finished animals from the investor when they are already for market.

Cattle feeding programs are not capital gain tax shelters but usually are a way to shift ordinary income from one year to another.

The second approach to cattle as a tax shelter lies in the ownership of breeding stock. Within this approach, there can be tax shelter programs created for commercial beef cattle, pure-bred herds, and even dairy cattle.

Most breeding programs involve a contractual arrangement to buy the offspring of the breeding animals, and once again, the terms of the agreements in great part determine the attractiveness of the deal.

Educational workshop: 6:30-10 p.m. Thursdays, March 6, 13, and 20 at MSU Management Center in Troy. $39 for workbook. Registration is necessary.

Call Elise at 643-8888 for registration and further information.

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