

# Balanced Books

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Maintaining your books and keeping track of depreciation are of the utmost importance when it comes time to sell your building.

I have a client who has owned and run his business successfully for several decades. He knows his books well and can easily point out the problem when numbers look off. He understands how valuable it is to have current books and records. Anytime a bank needs a financial report, he just prints it out from his accounting software and sends it to the bank immediately without any fuss. For example, when he wanted to refinance his property, he was easily able to get a copy of the past returns, and the year-to-date profit and loss report. He is curious and wants to understand his books. Entering data into the books is the first step, but the results of those entries need to be reviewed and analyzed.

In the following examples of the important data you can ascertain from your balance sheet, I am going to assume that you are in a partnership that owns at least one rental property. I will also assume that you use QuickBooks accounting software using cash basis books—meaning you record income when cash or checks come in, and expenses when cash, checks or credit cards are used.

## Cash Reconciliation

When you generate a balance sheet from QuickBooks, you will see the assets that the partnership has, the debts that the partnership owes (such as loans) and partners' capital as of the date that you

generate the report. For our discussion, let's modify this report to "as of date 12/31/2013" because the 2013 tax returns were the last filed tax returns.

Let's start with most common asset accounts: cash, property and equipment accounts. For cash, you are better off relying on how much cash you have in your books than looking at your online statement (assuming that your books are up to date). Cash balance per books and per bank does not always match. That can be absolutely normal when the books are current.

As an example, let's take the month of December 2013. In December, let's say you wrote ten checks to pay bills, two of which were written to pay utilities and mailed on December 30, 2013. You immediately recorded these payments in QuickBooks. Let's say that it took about a week for the two vendors to receive and cash those checks. This means that those checks were processed by the bank on January 6, 2014. Even though you issued and mailed the checks in December, your December bank statement will not reflect the two checks until January 2014 (the month the bank was presented with those two checks).

After receiving your December 2013 bank statement, you are now ready to compare what was recorded in the cash account in QuickBooks in December to what was processed by the bank in

December. You will notice that those two checks issued on December 30, 2013, are missing in your December bank statement, but you know you wrote them. This difference is consistent with what you know and you can explain why cash per the bank is higher than the cash per books. This process is called a "cash reconciliation."

How about rent checks you received from tenants but have not deposited yet? Let's say you received a rent check from a tenant for \$2,500 at the year's end and did not get to deposit it until January 2, 2014. Since you received the check in 2013, you recorded it in the books as rent being paid by the tenant in December. We call this check an "outstanding deposit" or "deposit in transit." The net amount of yet-to-be-deposited check and yet-to-be-cashed check payment is the reconciling difference in cash between the bank balance and the book balance.

Whenever a monthly bank statement becomes available to you, it would be a best practice to reconcile the cash account immediately. The reconciliation means checking what checks and deposits were processed by your bank and identifying what checks and deposits are still outstanding. If you find that checks have been outstanding for over six months, you need to follow up. Do you need to replace the checks? Did you pay the vendor twice? Did you forget to deposit checks? Always review your outstanding checks and deposits. If you rely on your bank balance instead of the book balance and withdraw cash, you may have an overdraft issue.

## Depreciation Deduction

When you acquire a piece of real estate, you record the purchase cost in QuickBooks. Please remember that the cost basis is not the purchase price you paid. If you look at your closing "final"

settlement statement, you will see various fees that were also paid through the escrow. Examples of these purchase costs are recording fees, transfer taxes, title services fees, appraisal fees and commissions.

Let's say the purchase price of your first rental property was \$1 million. If you add all the other fees listed in the purchase statement, the total cost of your property becomes \$1.1 million. If you do not provide this information to your tax preparer, you are neglecting the \$100,000 in costs that you paid or that were factored into the loan.

Your tax preparer uses the \$1.1-million cost to compute your annual depreciation deduction. This \$1.1-million cost is allocated between the land (nondepreciable) and the building (depreciable). This allocation is done based on a reasonable ratio (one method is to use the property tax bill for reference). The building portion is then depreciated beginning on the date the property becomes available for rent.

Depreciation is an annual deduction for aging and/or wear and tear approximation on your rental property. This depreciation deduction reduces your original cost basis of the property. Most likely, you get your annual depreciation deduction amount from your tax preparer and enter it into your books.

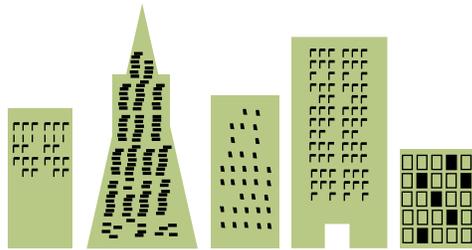
Where does the accumulation of past depreciation show in the books? You should have an account called "accumulated depreciation" in the asset section of the balance sheet. It is normal for this account to have a negative balance. For simplicity, this account has a negative value to show you the reduced cost basis of your property. When you know how much your property is worth, you simply deduct this reduced cost basis from the market price. (Of course, there are other additional expenses, such as selling expenses, to consider in calculating gains.)

Let's take a simple example. Let's say that ten years ago you bought a residential rental property for \$1.1 million. The

property was rented out for the entire ten years. This year, the market looks good and you are thinking of selling this property for \$1.3 million. How much is your gain? I will give you a hint: it is not \$200,000.

A depreciation deduction was taken every year the property was rented out. Let's assume that 70% of the property value (or \$875,000) was allocated to the building and 30% or (\$225,000) was allocated to land. You only depreciate the building and a residential rental building is depreciated over 27.5 years. In ten years, you will have taken a depreciation deduction of \$300,000. Your basis in this rental property is no longer \$1.1 million. It is now reduced to \$800,000. Therefore, after the sale at \$1.3 million, the gain is \$500,000.

As you can see, if you expected your gain to be the difference between the sales price and purchase price you will be in for a pleasant surprise of higher gain and a not-so-pleasant surprise of higher tax. Once a client told me, "You know, our mortgage interest and property taxes are high, so we do



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not really need this additional depreciation deduction. We just want to keep our basis intact so we have a low gain in a few years." That would be a great idea, but unfortunately it doesn't work that way.

The reality is that you use the depreciation deduction or lose it. Your basis in the property will still be reduced by the annual depreciation deduction whether you have taken it or not. Besides, you should not worry about losing the loss in excess of rental income. The loss can be limited or suspended now but it is carried forward until there is income to offset in the future or until the property is disposed. When property is disposed, the carried-forward loss is released and deducted in the same year.

#### Equipment, Furniture and Fixtures

Have you been asked by your tax preparer to break down the entire cost of a remodeling project by project categories? How much did it cost to remove and replace all cabinets, doors and appliances when you upgraded your building's kitchens? How much did you pay for landscaping in the common yard? This can be time-consuming work.

If you are being asked, your tax preparer is looking out for you. Appliances are depreciated over five years and cabinets over seven years. You want to get the deduction now and have lower taxable income. Remember to ask a lot of questions while things are happening. Most likely, your contractors can tell you what you need to separate the costs. They have probably been asked for this allocation many times.

#### Loan or Mortgage

Most partnerships with rental properties have loans secured by the properties. This loan account in your books should reflect the unpaid loan balance. Do your books reflect the correct balance? If you compare the balance of the lender's monthly statement to the balance per the books, do you see any difference? If you entered the monthly payments into your books correctly, you should either have the same balance or be able to easily explain why there is a difference between the books and the

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loan statement (just like the cash balance we discussed earlier).

Perhaps you sent the January 2014 loan payment check in December 2013 and that payment was reflected in the lender's January statement. This does not mean you posted the payment wrong, just that you can explain why there is a difference.

Sometimes the difference is caused by incorrectly entering the payment in the books. The most common mistake clients make in entering monthly mortgage payments is putting the payments in either the loan account or the interest expense account. This kind of input will result in either an understated loan balance and understated loan interest expense, or overstated loan interest expense with an overstated loan balance. You need to enter the payment split between the loan principal payment and interest expense in the books just like your lender does in its monthly loan statement. This way, your profit and loss statement shows the correct interest expense and the balance sheet shows the correct loan balance. If you have done the above and tied the balances or explained the difference, congratulations, you just reconciled your loan account.

By taking the lessons learned here and keeping your books current and complete, you will easily know your cash position. Then you will have the adjusted basis information available to estimate how much your gain will be if you were to sell your property.

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