ABOUT TAXATION
Taxation can have a significant impact on the cash return produced by investment real estate—both during ownership and at sale. Real estate managers have a responsibility to help owners achieve their financial goals for their properties. Thus, real estate managers must be aware of the tax laws that affect real estate.

A real estate manager’s clients are subject to two forms of federal tax on their real estate investments:

1. Annual income tax on rental income
2. Capital gains tax as a result of a sale of the property

This Skill Builder will not prepare you to be a tax expert. Tax laws are highly complex, and your client must obtain all tax advice from a tax accountant or tax attorney. In many jurisdictions, giving any form of tax or legal advice is unlawful if you are not licensed to practice accounting or law. A professional real estate manager must avoid giving any legal or tax advice for which he or she is not professionally trained.

INCOME TAX
Before-tax cash flow (BTCF) from real estate is the amount of cash available to the owner after disbursements for operating expenses and mortgage payments have been subtracted from effective gross income.

On the other hand, taxable income is the effective gross income less IRS allowable deductions. Income tax liability is calculated on taxable income, not cash flow. The tax liability is deducted from before-tax cash flow to determine after-tax cash flow.

\[
\text{Taxable Income} = \text{EGI} - \text{IRS Allowable Deductions}
\]
Income Deductions
The tax code specifies allowable deductions from income to determine taxable income. These deductions include the following:

<table>
<thead>
<tr>
<th>Factor</th>
<th>Description</th>
</tr>
</thead>
</table>
| Operating Expenses    | ▪ Tax laws provide for deductions for all expenses related to the production of income. These deductions include normal operating expenses.  
▪ Capital Improvements may be treated as an allowed expense deduction and require the expertise of an accountant to make that determination. A common mistake that owners and property managers make is to improperly classify an expensive repair as a capital improvement because of the large dollar amount. Even “big ticket” items can be expensed rather than depreciated over several years, such as an exterior paint, if it restores a property to a sound state. A capital improvement would be an expenditure that increases property value, extends its life expectancy, or supports a business expansion.  
▪ The difference in treating a repair as an expense or a capital item has a significant impact on an owner’s tax obligation.                                                                                     |
| Mortgage Interest     | ▪ While the total mortgage payment (Annual Debt Service includes both principal and interest) represents a direct reduction in cash flow, only the interest portion of the annual debt service may be deducted to calculate taxable income.  
▪ The amount borrowed is not treated as income when received, so principal payments are not treated as expenses and the principal portion reduces the liability on the balance sheet.                                                   |
| Cost Recovery         | ▪ The deduction for cost recovery (also called depreciation) relies on the premise that real estate is a wasting asset. That means the asset loses value with age and use. Therefore, under federal tax law, the owner may take a deduction from taxable income for the tangible property used up (through exhaustion, wear and tear, and normal obsolescence) in a trade or business or for the production of income.  
▪ Cost recovery reduces the net taxable income of the property.  
▪ Cost recovery deductions do not represent cash payments and therefore have no impact on cash flow. They are a “paper” expense only that is recognized on the taxpayer’s income tax form.  
▪ Cost recovery deductions are most often calculated using percentage tables provided in IRS Publication 946, How to Depreciate Property.                                                                                          |

**FEDEX CASE STUDY ON CLASSIFYING EXPENSES**

A most notable case is FedEx vs. United States, in which FedEx challenged the purchase of engines as an expense and not a capital improvement. The courts agreed that the airplane was the unit of property and the purchase of an engine was a maintenance expense. This case revolutionized how IRC section 195 is interpreted and real estate owners treat large expenses. There have been many more court cases to follow in support of the FedEx ruling.
Cost recovery deductions are most often calculated using percentage tables provided in IRS Publication 946, How to Depreciate Property.

- **TABLE A-6: RESIDENTIAL RENTAL PROPERTY**: Table A-6 is for Residential Rental Property using Mid-Month Convention and Straight Line depreciation--27.5 Years and lists the percentages for years 1 through 29 by month placed in service.

- **TABLE A-7: NONRESIDENTIAL REAL PROPERTY**: Table A-7 is for Nonresidential Real Property, using the Mid-Month Convention and Straight Line depreciation--31.5 years and lists the percentages for years 1 through 33 by month placed in service.

- **TABLE A-7A: NONRESIDENTIAL REAL PROPERTY**: Table A-7a is for Nonresidential Real Property, using the Mid-Month Convention and Straight Line depreciation--39 years and lists the percentages for years 1, 2-39, and 40 by month placed in service.

The mid-month convention is used for real property. This means that only half of a month’s depreciation is allowed in the months of acquisition and disposition, regardless of when during the month the property acquisition or disposition occurred.

Visit the IRS Web site at www.irs.gov for more information and to download IRS Publication 946, How to Depreciate Property.

**Cost Segregation**

Until recently, it was common to use the straight-line method (27.5 or 39 years) to calculate annual depreciation. Recent tax court rulings have acknowledged property owners’ ability to exercise accelerated depreciation using a method known as cost segregation. Using this method, the investor is allowed to take a higher amount of cost recovery in the early years of the investment by categorizing major building components into shorter life categories. For example, the HVAC system may be given a 7-year life span, the roofing a 15-year life span, etc. In so doing, the investor can take advantage of higher deductions in early years and use the savings for other investments. The total allowable cost recovery does not change, so if the investor holds the property long enough, the later years will see a smaller cost recovery allowances. In order to take advantage of this method, the owner must hire a professional analyst (usually an appraiser) to survey the building and make a reasonable determination of what the life span of each component is and categorize each item into 5, 7-, and 15-year life spans. The Cost Segregation Study can cost several thousand dollars, so not all properties may benefit. However, the study can go back to when the property was purchased or 1986, whichever occurred later, so the accumulated tax savings could be substantial.
COST SEGREGATION EXAMPLE

As shown in the following example, it may be advantageous for an owner to consider the cost of the study. A commercial building that costs $7,000,000 and has a land value of 20% would have a depreciable basis of $5,600,000 or $143,590 per year of allowable cost recovery. The table below displays cost recovery if the same building had itemized and totaled its components into the shorter life span categories:

Item Cost Recovery Allowed

<table>
<thead>
<tr>
<th>Item</th>
<th>Cost Recovery Allowed</th>
</tr>
</thead>
<tbody>
<tr>
<td>5-year items</td>
<td>$400,000</td>
</tr>
<tr>
<td>7-year items</td>
<td>$150,000</td>
</tr>
<tr>
<td>15-year items</td>
<td>$150,000</td>
</tr>
<tr>
<td>39-year items</td>
<td>$4,900,000</td>
</tr>
<tr>
<td>Annual Total Years 1-5</td>
<td>$237,070</td>
</tr>
</tbody>
</table>

As shown, for the first five years of the investment, the owner would be able to claim a deduction of $237,070 annually instead of $143,590, which would amount to $467,400 over the five years. As with most items related to ownership accounting, it is important to make sure your client gets professional advice from his or her accountant as to how cost segregation will fit specific needs.

Legal Issue: Congress has anticipated a review of depreciation since 2000, but other tax policy debates have intervened. If no new legislation is passed, the leasehold improvement depreciable life of nonresidential property will continue to be up to 39 years.

A 39-year depreciable life for tenant improvements is unrealistic in the eyes of investors. A realistic cost recovery period, such as 10-15 years, is a reasonable incentive to keep office, commercial, and retail space modern, efficient, and competitive between urban and suburban space. In addition, such a change would more closely mirror corresponding lease terms for these properties.

IREM® is in support of legislation to decrease the length of depreciable lives for tenant improvements to the length of the lease term. IREM® also supports legislative language that would allow any remainder of tenant improvement costs left upon early termination of the lease to be written off upon the termination of a lease, not over the depreciable life of a structure.
Before-Tax Cash Flow versus Taxable Income

The differences between calculating BTCF and taxable income in the following example result from amortization of principal in the BTCF column and allowance for cost recovery in the taxable income column.

<table>
<thead>
<tr>
<th></th>
<th>Before-Tax Cash Flow</th>
<th>After-Tax Cash Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>Effective Gross Income</td>
<td>$61,000</td>
<td>$61,000</td>
</tr>
<tr>
<td>Expenses</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>Net Operating Income</td>
<td>31,000</td>
<td>31,000</td>
</tr>
<tr>
<td>ADS-Principal</td>
<td>466</td>
<td>Not Deducted</td>
</tr>
<tr>
<td>ADS-Interest</td>
<td>27,971</td>
<td>27,971</td>
</tr>
<tr>
<td>Cost Recovery</td>
<td>Not Deducted</td>
<td>7,273</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>$2,563</td>
<td>($4,244)</td>
</tr>
</tbody>
</table>

Passive Income

A potential tax advantage exists whenever the operating income of a real estate investment is legitimately reduced through the application of the tax code. Today, potential tax advantages exist because of the mortgage interest deduction and the cost recovery deduction.

To reduce the role of tax shelters, the Tax Reform Act of 1986 created three categories of income-producing activities. By dividing income into three categories, Congress reduced much of the appeal of tax shelters. Now, only a limited amount of loss generated by passive activities can reduce taxable income generated by nonpassive activities.
IREM® Skill Builder: After-Tax Cash Flow Analysis

Total income is comprised of:

- **ACTIVE**: income and losses from salaries, wages, tips, commissions, and other trade or business activities in which a taxpayer materially participates
- **PORTFOLIO**: income and losses from interest, dividends, and royalties
- **PASSIVE**: there are three categories of passive income:
  1. Investments in which the taxpayer does not materially participate. Material participation means involvement in the operations of an activity throughout the year on a regular, continuous, and substantial basis.
  2. Limited business interest includes interest in investments in which the taxpayer’s liability is limited, for example, a limited partnership. Partners receive a K-1, which reports their portion of the property’s income and cost recovery.
  3. Most rental activity is specifically included in the passive income category, whether the taxpayer materially participates or not. Rental activity produces income that consists of payments for the use of tangible property rather than the performance of services.

All income and losses from activities within a category are aggregated within that category. Generally, net losses from passive activities can only offset net income from other passive activities. Any resulting net passive income is fully taxable in the year generated. The passive income is added to the taxable income from other income categories. Any resulting net passive loss is generally suspended until it can be used to offset net passive income generated in a future tax year or until the owner disposes of the property. Net losses from passive activities are allocated each year to those passive activities experiencing losses. Suspended passive losses may be carried forward indefinitely.

The suspended losses attributed to a property that have not been used against other income in previous years can be used to reduce taxable gains when the entire interest is sold to an unrelated third party in a taxable transaction. Offsetting ordinary income with the losses is better than using them to reduce capital gains on the property’s sale because ordinary income is taxed at a higher rate than capital gains. Because income and losses from all passive activities are aggregated, the law provides a method for allocating excess losses to a particular property. Generally, the portion of the suspended loss attributable to a specific property depends on the ratio of the loss from the property to the total loss from all passive activities. Suspended losses are deductible against income at the time of sale in a specific order—first, any gain recognized on the transaction; second, net income or gain for the tax year from all passive activities; third, active or portfolio income when interest in the activity is sold. If the taxpayer has already used the losses attributable to a property to offset income from other passive activities, he or she cannot use them again at disposition.
### IRS FORM 1040

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>7</td>
<td>Wages, salaries, tips, etc. Attach Form(s) W-2</td>
</tr>
<tr>
<td>8a</td>
<td>Taxable interest. Attach Schedule B if required</td>
</tr>
<tr>
<td>8b</td>
<td>Tax-exempt interest. Do not include on line 8a</td>
</tr>
<tr>
<td>9a</td>
<td>Ordinary dividends. Attach Schedule B if required</td>
</tr>
<tr>
<td>9b</td>
<td>Qualified dividends</td>
</tr>
<tr>
<td>10</td>
<td>Taxable refunds, credits, or offsets of state and local income taxes</td>
</tr>
<tr>
<td>11</td>
<td>Alimony received</td>
</tr>
<tr>
<td>12</td>
<td>Business income or (loss). Attach Schedule C or C-EZ</td>
</tr>
<tr>
<td>13</td>
<td>Capital gain or (loss). Attach Schedule D if required. If not required, check here</td>
</tr>
<tr>
<td>14</td>
<td>Other gains or (losses). Attach Form 4797</td>
</tr>
<tr>
<td>15a</td>
<td>IRA distributions</td>
</tr>
<tr>
<td>15b</td>
<td>Taxable amount</td>
</tr>
<tr>
<td>16a</td>
<td>Pensions and annuities</td>
</tr>
<tr>
<td>16b</td>
<td>Taxable amount</td>
</tr>
<tr>
<td>17</td>
<td>Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E</td>
</tr>
<tr>
<td>18</td>
<td>Farm income or (loss). Attach Schedule F</td>
</tr>
<tr>
<td>19</td>
<td>Unemployment compensation</td>
</tr>
<tr>
<td>20a</td>
<td>Social security benefits</td>
</tr>
<tr>
<td>20b</td>
<td>Taxable amount</td>
</tr>
<tr>
<td>21</td>
<td>Other income. List type and amount</td>
</tr>
<tr>
<td>22</td>
<td>Combine the amounts in the far right column for lines 7 through 21. This is your total income</td>
</tr>
</tbody>
</table>

Source: www.irs.gov
Exemptions and Exceptions
A limited exemption to the passive loss rules is available for taxpayers who invest in rental real estate. If three conditions are met, the taxpayer can use up to $25,000 in losses from real estate activities to offset nonpassive income:

1. The taxpayer must have an adjusted gross income (AGI) of less than $150,000. For every AGI dollar over $100,000, the $25,000 allowance is reduced by 50 cents. Therefore, the $25,000 exception is totally eliminated when AGI reaches $150,000.

2. The taxpayer must actively participate in the investment. Here, active participation is not the same as material participation. Active participation is far less restrictive and is only used when applying this limited exception. A taxpayer actively participates in an investment if he or she participates in making management decisions or in arranging to have others provide services (such as repairs) in a significant sense. The relevant management decisions include approving new tenants, rental terms, capital and repair expenditures, and other similar decisions.

3. The taxpayer must own at least a 10% interest in the investment—but not as a limited partner.

The taxpayer can only offset active income under this exception if net passive losses exist. Passive losses in excess of the $25,000 exception are suspended and carried forward subject to the same restrictions as other passive losses. If, due to insufficient active income, a taxpayer cannot use any of the passive losses under this exception, the unused loss becomes an active loss that can be carried back or forward as any ordinary loss can.

Real estate professionals can also write off the full amount of their net losses from real estate rentals against any category of income. The taxpayer must satisfy three conditions to qualify for this exception:

1. The taxpayer must materially participate in the real estate business. His or her activity must be regular, continuous, and substantial and not as a limited partner.

2. More than half the personal services the taxpayer performs for any business (as defined below) must be for his or her real property.

3. The taxpayer must perform more than 750 hours of service during the year in real property trades or businesses. Real property trades or businesses include real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage. Each rental real estate operation is generally treated as a separate activity to test the taxpayer’s level of participation. However, the taxpayer may elect to treat all interests in rental real estate as one activity.

If a taxpayer meets the previously stated conditions, the excepted passive losses may be used against all other income, whether it can be used in that tax year or not. (Whether a taxpayer qualifies for the exception is determined each year.) The taxpayer cannot make use of the deductions available under the exceptions unless net passive losses are available from real estate. For example, if an investor has two passive investments, a partnership providing $15,000 in income and a real estate investment providing $25,000 in losses, only the net loss of $10,000 may be used to offset other income, not the entire $25,000 real estate loss.
LIMITED EXCEPTION FOR REAL ESTATE

INCOME TAX SAVINGS/PAYABLE STEPS

1. Determine NOI
2. Subtract Mortgage Interest
3. Subtract Cost Recovery
4. Taxable Income
5. Other Passive Losses to Offset?
6. Exemptions or Exceptions?
7. Multiply by Tax Bracket

Income Tax Savings/Payable Steps
The following figure outlines the income tax savings/payable steps.
EXAMPLE #1

The Mayfair property was purchased by your client for $6,000,000 with a $1,500,000 down payment and a 30-year $4,500,000 mortgage with a 7% rate (assume monthly payments). No points or fees were charged.

Gross Potential Income (GPI) is expected to be $775,000 in Year 1. Operating expenses are expected to be $300,000 in Year 1. Both are expected to increase by 2% each year. The property is expected to sell at the end of Year 5 at an 8% going-out capitalization rate. The costs of sale are expected to be 5%. The owner’s required return is 10%.

We also know that this is an apartment community with land allocation of 20% and improvements of 80%. Your client is in a 30% income tax bracket. She has also hired a professional AMO® management firm.

You can use the IREM® Financial Analysis Spreadsheet, After-Tax Cash Flow tab, to conduct the following analysis.
IREM® Skill Builder: After-Tax Cash Flow Analysis

Step 1: Determine NOI

Step 2: Subtract Mortgage Interest
**Step 3: Subtract Cost Recovery**
Mayfair is a residential property and allowed cost recovery over 27.5 years.

<table>
<thead>
<tr>
<th>COST RECOVERY</th>
<th>Amount</th>
<th>Recovery</th>
<th>Per.</th>
<th>Cost Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price + Acq. Exp.</td>
<td>6,000,000</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Land Allocation</td>
<td>1,200,000</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Building Allocation</td>
<td>4,800,000</td>
<td>27.5</td>
<td>174,545</td>
<td>174,545</td>
</tr>
<tr>
<td>Personal Property</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Loan 1 Points, Fees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Capital Improvements</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Loan 2 Points, Fees</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Annual Total</td>
<td></td>
<td></td>
<td></td>
<td>174,545</td>
</tr>
</tbody>
</table>

**Step 4: Result is Taxable Income**
Taxable Income = NOI – Mortgage Interest – Cost Recovery.

<table>
<thead>
<tr>
<th>Year</th>
<th>NOI</th>
<th>-Interest deduction</th>
<th>-Cost Recovery</th>
<th>=Taxable Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>475,000</td>
<td>-313,552</td>
<td>-174,545</td>
<td>(13,097)</td>
</tr>
<tr>
<td>2</td>
<td>484,500</td>
<td>-310,247</td>
<td>-174,545</td>
<td>(293)</td>
</tr>
<tr>
<td>3</td>
<td>494,190</td>
<td>-306,704</td>
<td>-174,545</td>
<td>12,940</td>
</tr>
<tr>
<td>4</td>
<td>504,074</td>
<td>-302,905</td>
<td>-174,545</td>
<td>26,624</td>
</tr>
<tr>
<td>5</td>
<td>514,155</td>
<td>-298,830</td>
<td>-174,545</td>
<td>40,779</td>
</tr>
</tbody>
</table>

**Step 5: Determine if Tax Savings are Offset by Passive Losses**
Passive income in the amount of $25,000 is available each year from another real estate venture. Therefore, the entire Taxable Income is multiplied by 30% to create a Tax Savings in Years 1-3. This reduces the Tax Payable in Years 4-5.

If there wasn’t an income from another venture available to offset the losses, the negative Taxable Income would be suspended for use in future years.

Prior suspended losses may also be used to reduce income and the tax payable.

<table>
<thead>
<tr>
<th>CASH FLOW AND TAXABLE IN</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOI</td>
<td>475,000</td>
<td>484,500</td>
<td>494,190</td>
<td>504,074</td>
<td>514,155</td>
</tr>
<tr>
<td>Loan Principal</td>
<td>45,711</td>
<td>45,016</td>
<td>52,553</td>
<td>56,359</td>
<td>60,433</td>
</tr>
<tr>
<td>Loan Interest</td>
<td>313,552</td>
<td>310,247</td>
<td>306,704</td>
<td>302,905</td>
<td>298,830</td>
</tr>
<tr>
<td>BCF</td>
<td>115,737</td>
<td>125,237</td>
<td>134,927</td>
<td>144,310</td>
<td>154,832</td>
</tr>
<tr>
<td>Cost Recovery</td>
<td>174,545</td>
<td>174,545</td>
<td>174,545</td>
<td>174,545</td>
<td>174,545</td>
</tr>
<tr>
<td>Tax Deduction</td>
<td>488,037</td>
<td>484,733</td>
<td>481,250</td>
<td>477,450</td>
<td>473,376</td>
</tr>
<tr>
<td>Taxable Income</td>
<td>(13,097)</td>
<td>(293)</td>
<td>12,940</td>
<td>26,624</td>
<td>40,779</td>
</tr>
<tr>
<td>Prev. Susp. Loss</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Passive Income Avail</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td>Passive Losses Used</td>
<td>13,097</td>
<td>293</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Tax Savings/Payable</td>
<td>3,929</td>
<td>88</td>
<td>(3,882)</td>
<td>(7,387)</td>
<td>(12,234)</td>
</tr>
<tr>
<td>ATCF</td>
<td>$113,666</td>
<td>$125,325</td>
<td>$131,045</td>
<td>$136,823</td>
<td>$142,658</td>
</tr>
</tbody>
</table>
Step 6: *Determine any Exemptions or Exceptions*

Your client is in a 30% income tax bracket and exceeds the $150,000 ceiling and has hired a highly respected AMO® firm to manage the day-to-day operation. Therefore, she does not qualify for any exemptions or exceptions.

Step 7: *Multiply by the Tax Bracket*

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxable Income</td>
<td>(13,097)</td>
<td>(293)</td>
<td>12,940</td>
<td>26,624</td>
<td>40,779</td>
</tr>
<tr>
<td>Passive Income Avail</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
<td>25,000</td>
</tr>
<tr>
<td>30% Tax Savings/Payable</td>
<td>3,929</td>
<td>88</td>
<td>(3,882)</td>
<td>(7,987)</td>
<td>(12,234)</td>
</tr>
</tbody>
</table>

The tax savings is added to the before-tax cash flow to determine the after-tax cash flow.

If the taxable income is positive and there isn’t a loss to offset, it is multiplied by the tax rate and becomes a tax payable. A tax payable will reduce the after-tax cash flow.

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before-Tax Cash Flow</td>
<td>115,737</td>
<td>125,237</td>
<td>134,927</td>
<td>144,810</td>
<td>154,892</td>
</tr>
<tr>
<td>+Tax Savings/Payable</td>
<td>3,929</td>
<td>88</td>
<td>(3,882)</td>
<td>(7,987)</td>
<td>(12,234)</td>
</tr>
<tr>
<td>=After-Tax Cash Flow</td>
<td>$119,666</td>
<td>$125,325</td>
<td>$131,045</td>
<td>$136,823</td>
<td>$142,658</td>
</tr>
</tbody>
</table>
**CAPITAL GAINS TAX**

Capital appreciation results from an increase in the value of a property and is subject to *capital gains tax* (rather than income tax). Taxes on this equity appreciation, however, are not paid unless the property, or interest in the property, is sold. Capital gains tax is paid not only on the equity appreciation but also on recapture of cost recovery written off during the holding period.

The capital gains tax rate is subject to frequent and abrupt revision by Congress. The capital gains rate influences investor willingness to buy and sell property. The higher the tax, the less likely an owner with equity appreciation is to sell. The reverse motivation exists with lower capital gains taxes. 

*Basis* for a purchased property equals the total purchase price of the property. The amount of financing is also included in the property’s basis. Basis increases with any capital improvements to the property and decreases by the cost recovery deductions taken. An understanding of basis is necessary to determine cost recovery, gain or loss upon the sale of a property, and amortization deductions. This discussion covers three kinds of basis:

<table>
<thead>
<tr>
<th>Basis</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Original Basis</strong></td>
<td>• Original basis (at acquisition) of a property for tax purposes is the purchase price plus any other costs of acquisition that are capitalized.</td>
</tr>
<tr>
<td></td>
<td>• Generally all costs of acquisition are added to the basis except deductible income and expense prorations (property taxes, insurance, etc.).</td>
</tr>
<tr>
<td><strong>Recoverable Basis</strong></td>
<td>• Includes the value of improvements only. Land is not depreciable for tax purposes. The original basis must be allocated between land and improvements to determine recoverable basis.</td>
</tr>
<tr>
<td></td>
<td>• Many investors prefer to allocate as much of the original basis as is legally defensible to improvements to maximize cost recovery deductions and shelter as much income as possible.</td>
</tr>
<tr>
<td><strong>Adjusted Basis</strong></td>
<td>• Calculated by adjusting the original basis upward or downward over the holding period of the asset to reflect added capital improvements and subtracted cost recovery.</td>
</tr>
</tbody>
</table>

**Allocating Basis**

Basis is used to determine cost recovery by allocating the total basis of the property between land, improvements, and personal property. This allocation is done because improvements and personal property are subject to cost recovery; land is not. The amount of basis allocated to improvements and personal property is thus called *depreciable basis*.

For the purposes of the IREM® Asset Analysis courses, basis will be allocated between land and improvements. (Personal property includes items such as furniture, computer systems, and appliances.) Basis can be allocated using any defensible, reasonable method, including professional appraisal or tax assessment. Taxpayers should use a method that provides the maximum basis and thus, the maximum financial benefit.

IREM® Skill Builder: After-Tax Cash Flow Analysis

Reform Act of 1986. Under the MACRS, deductions are greater in the early years of ownership and decrease in later years. The same amount of tax is paid over any selected cost recovery method; however, the MACRS generally allows greater tax savings in earlier years, which is beneficial due to the time value of money. Cost recovery allowances convert to straight-line percentages when straight-line deductions begin to exceed the accelerated deductions. The present tax law includes penalties (recapture) for using the MACRS on real estate; it taxes part or all of the capital gain as ordinary income when the property is sold.

In the straight-line method, deductions for cost recovery remain the same for each year of ownership. Rental real estate placed in use after 1986 must use the straight-line method. Straight-line cost recovery may also be elected for other types of property.

1031 Exchanges
A 1031 Exchange, also known as a Like-Kind Exchange, is a way of structuring a sale of certain kinds of property pursuant to Internal Revenue Code (IRC) Section 1031 so that the seller's profit or gain is not taxed at the time of sale. The condition for this benefit is that the property that is sold be replaced with another "like-kind" property. If the transaction is properly structured, the seller’s profit or gain is deferred to a future date.

This allows an investor to sell the property and effectively transfer the gain to another property; thereby allowing one to realize profits, yet not pay the tax due—at least for now. The transfer reduces the basis of the new property purchased by an amount equal to the gain. When the second property is sold, it will thereby produce a correspondingly higher gain than it would have otherwise and that new higher amount will then be subject to taxation. The exchange does not reduce the taxes, but rather defers them to a later date. An investor could gauge the decision on when to sell based on a determination of whether the current capital gains rate is advantageous, or whether it is better to transfer the gain to another property. There is no current limit to the number of times the investor can exchange, so a second sale can be exchanged into a third and so on, as long as the basis remains a positive number.

The sale of the relinquished property and the acquisition of the replacement property do not have to be simultaneous. A nonsimultaneous exchange is sometimes called a Starker Tax Deferred Exchange (named for an investor who challenged and won a case against the IRS). For a non-simultaneous exchange, the taxpayer must use a qualified intermediary, follow guidelines of the IRS, and use the proceeds of the sale to buy more qualifying, like-kind property. Most title companies provide intermediary services for an additional fee. The replacement property must be identified within 45 days after the sale of the old property, and the acquisition of the replacement property must be closed within 180 days of the sale of the old property. In addition, the investor cannot receive the money in the interim; it must be held by the intermediary.

Tenants in Common Exchanges
Tenants in Common (TIC) ownership is a form of real estate ownership in which two or more persons have an undivided, fractional interest in the asset, where ownership shares are not required to be equal, and where ownership interests can be inherited. Each co-owner receives an individual deed at closing for his or her undivided percentage interest in the entire property. Although the TIC ownership form has been used for many years, its popularity has been increasing dramatically due to a 2002 IRS ruling that greatly expanded the pool of available properties. Exchangers often have difficulty locating and closing suitable replacement property
within the 45-day identification period and the 180-day closing period. An exchange into a TIC interest can address these issues. In addition, a 1031 TIC structure can allow investors to pool their resources and purchase larger, higher-valued and better-positioned properties than they might otherwise be able to acquire. Typically these more prestigious properties can also open doors to high-quality tenants, such as Fortune 500 companies and government entities, reducing tenant credit risk. Realestate firms (sponsors) organize the TIC-owned properties with professional management, removing day-to-day ownership concerns.

**Legal Issue:** President Bush signed the Tax Prevention and Reconciliation Act, H.R. 4297, on May 17, 2006. The law contains a key provision that extended tax cuts on dividends and capital gains for an additional two years. This was strongly supported by IREM® because of its impact on commercial real estate professionals. The current rate is 15% if held over 12 months but is always subject to change by Congress and an increase has been debated. Rates for any investment held under 12 months are taxed at the ordinary rate; however, all IREM® examples will be held longer than 12 months.

Favorable capital gains tax rates provide a boost for owners who wish to sell appreciated property. Lower rates alleviate the so-called “lock-in” effect, in which taxpayers are hesitant to sell property due to the high tax costs associated with sales. Also, lower capital gains rates alleviate in part the built-in gain that results from inflation.

IREM® believes that it is in our nation's best interest for Congress to encourage real estate investment in the United States by creating a tax system that recognizes inflation and creates a meaningful differential between the tax rates for ordinary income and those for capital gains. In addition, IREM® supports a level playing field for those who choose to invest in real estate and thus opposes rates for depreciation recapture that are higher than capital gains rate.

**Calculating Capital Gains Tax**

Capital gains tax is based on the *adjusted basis* in the property. The taxable gain or loss from the sale of the property is the difference between the net sale price and the adjusted basis of the property.

Therefore, anything that increases adjusted basis reduces the taxable gain on a sale, and anything that reduces adjusted basis increases the taxable gain on a sale.

Under current law, real estate gains are taxed at two different capital gain rates when a property sells for more than its original purchase price plus any capital improvements:

1. All of the capital gain attributable to cost recovery deductions is taxed at 25%. For most real estate, the adjusted basis plus cost recovery equals original purchase price.
2. Any remaining gain, that is, everything above the original purchase price, is taxed like other long-term capital gains at a 5% or 15% rate, depending on the taxpayer’s income bracket:
The tax liability upon sale must be determined to calculate the Net Sales Proceeds.

### TAX DUE ON SALE

1. **Calculate Adjusted Basis**
   
   (Original Basis + Cap Imp - Cost Recovery)

2. **Calculate Taxable Gain**
   
   (Sale price - Costs of Sale - Adjusted Basis)

3. **Calculate Tax Liability on Sale**
   
   (Cost Recovery @ 25%; Capital Gains @ 5% or 15%)

4. **Calculate After-Tax Net Sales Proceeds**
EXAMPLE #2

Recall again the Mayfair Property from the previous example:

The Mayfair property was purchased by your client for $6,000,000 with a $1,500,000 down payment and a 30-year $4,500,000 mortgage with a 7% rate (assume monthly payments). No points or fees were charged.

Gross Potential Income (GPI) is expected to be $775,000 in Year 1. Operating expenses are expected to be $300,000 in Year 1. Both are expected to increase by 2% each year. The property is expected to sell at the end of Year 5 at an 8% going-out capitalization rate. The costs of sale are expected to be 5%. The owner’s required return is 10%.

It is an apartment community with land allocation of 20% and improvements of 80%. Your client is in a 30% income tax bracket.

The owner also owns an office building that provides a $25,000 passive income annually. After 5 years of ownership, the sale price of Mayfair is $6,555,480.
Step 1: Calculate Adjusted Basis

Original Basis $6,000,000
- Land -1,200,000
= Recoverable Basis $4,800,000

Calculate total cost recovery.

<table>
<thead>
<tr>
<th>Year</th>
<th>Cost Recovery</th>
</tr>
</thead>
<tbody>
<tr>
<td>1st year</td>
<td>+174,545</td>
</tr>
<tr>
<td>2nd year</td>
<td>+174,545</td>
</tr>
<tr>
<td>3rd year</td>
<td>+174,545</td>
</tr>
<tr>
<td>4th year</td>
<td>+174,545</td>
</tr>
<tr>
<td>5th year</td>
<td>+174,545</td>
</tr>
</tbody>
</table>
= Total Cost Recovery $872,727

Calculate adjusted basis.

Original Basis $6,000,000
+ Capital Improvements +0
- Cost Recovery -872,727
= Adjusted Basis $5,127,273

Step 2: Calculate Taxable Gain

Sale Price $6,555,480
- Costs of Sale (5%) -327,774
- Adjusted Basis -5,127,273
= Taxable Gain on Sale $1,100,433

Step 3: Calculate Total Tax Liability

Taxable Gain on Sale $1,100,433
- Cost Recovery -872,727
= Capital Gain $227,706

Capital Gain Due to Cost Recovery $872,727 x 25% = $218,182
Remaining Capital Gain $227,706 x 15% = $34,156
Total Capital Gains Tax $252,338
IREM® Skill Builder: After-Tax Cash Flow Analysis

Step 4: Calculate the After-Tax Net Sales Proceeds

Sale Price $6,555,480
- Costs of Sale (5%) -327,774
- Mortgage Balance -4,235,922
= Before-Tax Sales Proceeds $1,991,784
- Tax Liability -252,338
= After-Tax Net Sales Proceeds $1,739,446

<table>
<thead>
<tr>
<th>A</th>
<th>B</th>
<th>C</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>After-Tax Cash Flow Analysis</td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>Instructions: Enter data in the yellow cells on</td>
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</tr>
<tr>
<td>3</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>Site:</td>
<td>For:</td>
</tr>
<tr>
<td>5</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td>ANALYSIS VARIABLES</td>
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<tr>
<td>7</td>
<td>LOAN 1</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td>Loan Amount</td>
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<td>9</td>
<td>Loan Interest Rate</td>
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<td>10</td>
<td>Loan Amortization Period (years)</td>
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<td>Owner's Required Return</td>
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<td>Going-Out Capitalization Rate</td>
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<td>19</td>
<td>Cost of Sale</td>
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</tr>
<tr>
<td>20</td>
<td>Income Tax Rate</td>
<td>30%</td>
</tr>
<tr>
<td>21</td>
<td>Recapture Rate</td>
<td>25%</td>
</tr>
<tr>
<td>22</td>
<td>Capital Gains Rate</td>
<td>15%</td>
</tr>
<tr>
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</table>

PROCEEDS OF SALE ANAL

<table>
<thead>
<tr>
<th></th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
<th>Year 5</th>
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<tr>
<td>Original Basis</td>
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<td>$6,000,000</td>
<td>$6,000,000</td>
<td>$6,000,000</td>
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<tr>
<td>+ Capital Imp</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
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<tr>
<td>- Cost Recovery</td>
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<td>-349,031</td>
<td>-523,636</td>
<td>-658,192</td>
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<tr>
<td>= Adjusted Basis</td>
<td>$5,825,455</td>
<td>$5,650,969</td>
<td>$5,476,364</td>
<td>$5,301,318</td>
<td>$5,127,273</td>
</tr>
<tr>
<td>Sale Price</td>
<td>$6,000,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$6,555,480</td>
</tr>
<tr>
<td>- Cost of Sale</td>
<td>-300,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-327,774</td>
</tr>
<tr>
<td>= Adjusted Basis</td>
<td>$5,825,455</td>
<td>$5,650,969</td>
<td>$5,476,364</td>
<td>$5,301,318</td>
<td>$5,127,273</td>
</tr>
<tr>
<td>= Gain</td>
<td>($25,545)</td>
<td>-</td>
<td>-</td>
<td>-</td>
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</tr>
<tr>
<td>- Suspended Losses</td>
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<tr>
<td>= Net Gain</td>
<td>($25,545)</td>
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<td>$0</td>
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<td>Recapture</td>
<td>$43,636</td>
<td>$87,273</td>
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<td>$218,182</td>
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<td>Additional Gain</td>
<td>($45,000)</td>
<td>($92,364)</td>
<td>($168,545)</td>
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<td>($34,156)</td>
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<td>$34,903</td>
<td>$52,364</td>
<td>$63,318</td>
<td>$252,338</td>
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<tr>
<td>Sale Price</td>
<td>$6,000,000</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>$6,555,480</td>
</tr>
<tr>
<td>- Cost of Sale</td>
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<td>$52,364</td>
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<td>= Net Sales Proceeds</td>
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<td>($34,903)</td>
<td>($52,364)</td>
<td>($63,318)</td>
<td>$1,733,447</td>
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</tbody>
</table>
IREM® Skill Builder: After-Tax Cash Flow Analysis

With the calculation of the recapture, this makes the actual capital gain tax approximately 22.9% of the gain.

**Standalone DCF Analysis**

**Before-Tax and After-Tax T-Bar**

<table>
<thead>
<tr>
<th></th>
<th>Before Tax</th>
<th></th>
<th>After Tax</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>N</td>
<td>$</td>
<td>$NSP</td>
<td>Total Cash Flows</td>
<td>$</td>
</tr>
<tr>
<td>0</td>
<td>($1,500,000.00)</td>
<td>($1,500,000.00)</td>
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<tr>
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**Financial Measures**

<table>
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<tr>
<th></th>
<th>Before-Tax</th>
<th></th>
<th>After-Tax</th>
<th></th>
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</thead>
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<tr>
<td>$/$%</td>
<td>7.72%</td>
<td>7.98%</td>
<td>Value Enhancement</td>
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</tr>
<tr>
<td>IRR</td>
<td>13.82%</td>
<td>11.21%</td>
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<td>$241,913</td>
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</table>