

RE 618 / Fin 618 – Real Estate Investment Analysis
Taxation of Real Estate Investments I – Lecture Notes

1) Introduction to Taxes

a) Many types of taxes must be paid on real estate investments:

- Real property taxes (ad valorem taxes)
 - Special assessments

- Income taxes on the operation of the property
 - Federal income taxes
 - State & local income taxes

- Capital gains taxes on the disposition of the property

Our focus is on the federal income and capital gains tax treatment of real property investments.

b) The “tax world” vs. the “real world”

- *Cash flows from operations*

<u>Real World</u>		<u>Tax World</u>
Net Operating Income		Net Operating Income
– <u>Annual Debt Service</u>		– Mortgage Interest
Before-tax Cash Flow		– Depreciation
– <u>Taxes from Operations</u>		– <u>Amortized Expenses</u>
After-tax Cash Flow		Taxable Income
		× <u>Marginal Tax Rate</u>
		Taxes from Operations

- *Cash flows from the sale of the property*

<u>Real World</u>	<u>Tax World</u>
Sale Price	Sale Price
– <u>Costs of Sale</u>	– <u>Costs of Sale</u>
Net Sale Price	Net Sale Price
– <u>Mortgage Balance</u>	– <u>Adjusted Basis</u>
Before-tax Equity Reversion	Total Gain from Sale
– Capital Gains Taxes	– <u>SL Cost Recovery</u>
– Depreciation Recapture	Gain from Appreciation
+ <u>Unclaimed Amortization</u>	Gain from Appreciation
After-tax Equity Reversion	× <u>Cap. Gains Tax Rate</u>
	Capital Gains Taxes
	SL Cost Recovery
	× <u>Dep. Recapture Rate</u>
	Depreciation Recapture

c) Ownership Structures

- Most real estate investments are held in an ownership structure that eliminates double taxation and yet still provides limited liability for the investors
 - Limited Partnerships
 - Limited Liability Corporations
 - Limited Liability Partnerships
 - REITs
- Our focus, therefore is on the individual income tax treatment of real estate investments.

d) Other Tax Wrinkles We Will Discuss

- Passive loss limitations
- Installment sales
- Like-kind exchanges

2) Tax Basis

a) Initial Basis

- The initial basis of a purchased property is the total purchase price plus all costs associated with purchasing the property.
 - Example: Suppose you are about to purchase a property using a cash down payment of \$1 million and a new \$4 million first mortgage. To purchase the property you expect to pay \$200,000 in remediation costs to fix an environmental problem with the site. What is your initial tax basis in this property?

b) Allocation of Initial Tax Basis

- Vacant land
 - In the case of vacant land, an allocation of basis is made to each individual lot or parcel of an overall tract in order to determine the gain or loss upon disposition of each lot or parcel.
- Improved property
 - The initial tax basis must be allocated between land, improvements, and personal property.
 - Land is not depreciable for tax purposes; personal property is eligible for an accelerated depreciation schedule.

- Methods for allocating basis:
 - Tax assessor’s ratio of land value to total value
 - Professional appraisal
 - Values explicitly stated in the purchase contract

As long as the values are legally defensible, you may pick the one that gives you the highest value to improvements, and thus the most tax benefits.

- Example: A property is acquired with a down payment of \$625,000 cash plus a mortgage of \$1,875,000. The following values were assigned by the tax assessor and the property appraisal:

	Tax Assessor	Appraisal
Land	\$400,000	\$390,000
Improvements	<u>1,600,000</u>	<u>2,210,000</u>
Total	\$2,000,000	\$2,600,000

What is the total basis in this property, and what is the proper allocation between the land and improvements?

3) Calculating Taxable Income

a) Depreciation allowances

- All real estate is depreciated using a straight line method with a mid-month convention.
 - Residential real estate improvements are depreciated over 27.5 years

Example: Suppose the property in the example on the last page is a residential property, and is put in service July 1. It will be in service for 4.5 years, being sold on December 31st. What is the depreciation allowance for years 1 through 5?

- Commercial real estate improvements are depreciated over 39 years.

Example: Suppose instead that the property from before is a commercial property. What will be the depreciation allowance in each of the five years of the expected holding period?

- Improvements made to the property after the date of service:

- Tenant improvements – Leased space usually will require refurbishing and improvements to tailor the space to the new tenant’s needs. The tax treatment depends on who pays for the improvements.
 - Owner pays for tenant improvements

 - Tenant makes and pays for improvements in lieu of rent

 - Tenant makes and pays for improvements not in lieu of rent.

b) Amortized loan expenses

- Up-front financing costs (e.g., points and fees associated with the loan) are amortized over the life of the loan.
 - Closing costs on the purchase (e.g., due diligence) _____ in the initial basis, not as a part of the financing costs.

 - The life of the loan is what matters, not the amortization schedule.

 - No mid-month convention is used.

c) Interest expenses

- Interest is based on the amortization schedule from the loan.

- Example:
 - In the loan from the last example, the monthly payment is:

 - Interest paid in each of the first five years will be:

d) Example of calculating taxable income and after-tax cash flow:

- Suppose that the property from before is a residential property that you have purchased at a 10 percent cap rate. Suppose also that NOI is expected to remain constant in the future. What is the taxable income for each of the first five years?

- What is after-tax cash flow (ATCF) in each of these years?
Assume a 35% marginal tax rate.

4) Passive Income Rules

- a) Notice that in the example we've been doing, our taxable income was always positive. What would happen if taxable income were negative in one year?

- It may be that the negative income will count as a tax credit, allowing the investor to use this tax loss to shield other income.

- b) Income for individuals is divided into three "baskets":

- Active income
 - Salary, wages, commissions and tips.
 - Income from trade or business activities in which the taxpayer "materially participates."

- Portfolio income
 - This includes interest, dividends, royalties, and gains or losses attributable to the disposition of portfolio property (e.g., stock and bond investments).

- Passive income
 - Income from trade or business in which the taxpayer does not materially participate.
 - Rental real estate has been specifically identified as passive, regardless of management participation.
 - A limited partner's income is passive by definition.

- c) Passive loss rule: *No losses from passive activities may shelter active or portfolio income.*
 - Net positive income from all three baskets is added together and taxed at the ordinary income tax rate.

 - Income and loss generated within the *active* and *portfolio* baskets can be netted against each other. For example, short-term losses on the sale of stocks from the portfolio basket can be netted against salary income or other active income.

 - Income within each basket may be offset by losses *within* that basket

 - Net losses from the passive basket can be *carried forward* to shield taxes on passive income in future years.
 - Cumulative losses generally are allowed in full against any gain to be reported on the sale of the property, or are reported as additional losses if the property is sold at a loss.

- Examples:

Active Income	\$100,000
Portfolio Income	\$50,000
Passive Income	\$50,000
⇒ Total income	

Active Income	\$100,000
Portfolio Income	(\$3,000)
Passive Income	\$50,000
⇒ Total income	

Active Income	\$175,000
Portfolio Income	\$75,000
Passive Income	\$50,000 & (\$10,000)
⇒ Total income	

Active Income	\$175,000
Portfolio Income	\$75,000
Passive Income	(\$100,000) & \$50,000
⇒ Total taxable income	

- The key importance for our purposes is whether or not you can claim a tax credit for negative taxable income from a property:
 - If the property generates positive taxable income, this is taxed at the investor’s marginal tax rate.
 - If the property generates negative taxable income, whether you can claim the loss depends on whether you have other passive income against which to offset this loss:
 - If you have other real estate or other passive activities that are generating positive income, you can use the loss to shield this income
 - If you do not have any other passive income, you must defer this income into the future until you have positive passive income to use it against.

d) Passive loss rule example: Suppose an investor has a property that generates the following passive income (taxable income before the passive loss rules are applied) follows:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Pass. Inc.	345,000	(150,000)	(100,000)	200,000	250,000

- What will be this investor's taxable income in each year?

- Suppose the investor has \$125,000 per year in other passive income. How will this affect his taxable income calculations?

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Pass. Inc.	345,000	(150,000)	(100,000)	200,000	250,000
Other PI	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>	<u>125,000</u>
Total PI					
LCF	_____	_____	_____	_____	_____
Tax. Inc.					

- Note that this can change from year-to-year based on other passive income that you may have.
 - Thus in one year you may have to defer your losses because you have no other passive income, but in the following year you may be able to claim your losses.
- e) *Rental Real Estate Loss Allowance*. Individual taxpayers (only) that “actively participate” in the management of a real estate activity may use up to \$25,000 of passive losses to offset active or portfolio income.
 - This exception is phased out for single and married-filing-jointly taxpayers with more than \$100,000 in AGI, not including net negative passive income. The phase out is \$0.50 per \$1.00 income over \$100,000, so the \$25,000 exception is completely phased out for income over \$150,000.
 - Suppose an individual investor has active income of \$100,000, portfolio income of \$20,000 and losses on a real estate investment totaling \$25,000. What is the investor’s taxable income in that year if he qualifies for the rental real estate loss allowance?