

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

5) Capital Gains and Tax Consequences Due to the Sale of Real Estate

a) Calculating Tax Consequences from the Sale

- Example: Continue the example from before:
 - \$2.5 million purchase price
 - 75% LTV mortgage over 25 years at 8.5 percent interest with 2 points
 - 4.5-year holding period

Suppose we sell the property at an 8 percent cap rate and that the costs of sale will be 5 percent of the sale price.

b) Effect of Passive Activity Loss Restrictions on Disposition

- Current or suspended losses from operating the property are used to reduce the gain from the sale of the property. In fact, they can be used to create a capital loss.
 - Suspended losses from other passive activity properties can be used to reduce the capital gain, but they cannot be used to create a capital loss.

6) After-tax Investment Analysis

a) Continue the example from before.

- Up-front cash flows:
 - Recall we have a \$2.5 million purchase price and a \$1.875 mortgage with two points:

- We calculated the annual operating cash flows before:

<u>Year</u>	<u>Cash Flow</u>
1	31,537
2	64,816
3	64,084
4	63,288
5	61,294

- The cash from the sale of the property is:

Sale price	
- Costs of sale	_____
Net sales price	
- Mortgage balance	_____
Before-tax equity reversion	
- Capital gains taxes at sale	
- Depreciation recapture tax	
+ Credit for unamortized points	_____
After-tax equity reversion	

- Thus, the total cash flows for this property are:

<u>Year</u>	<u>Cash Flow</u>
0	(662,500)
1	31,537
2	64,816
3	64,084
4	63,288
5	61,294 + 1,064,336 = 1,125,630

The NPV of this investment (@ 15 percent) is _____.

The IRR of this investment is _____.

7) Other Real Estate Income Tax Wrinkles

a) Installment Sales

- Suppose you were to sell the property but carry a note for the buyer. In this case, you might end up with a capital gains tax liability that exceeds any up-front cash you actually receive.

The tax code allows you to recognize your gain at the time you actually receive payments, rather than when the transaction closes, thus avoiding this problem.

- Realized gain is the actual capital gain on the property.
- Recognized gain is the gain on which the investor will be taxed.

b) Tax-deferred (1031) Exchanges

- At times an investor would like to remain invested in real estate, but alter the specific investment.
 - Tax-deferred exchanges allow you to do this without paying capital gains taxes on the transaction.

- Advantages:

- Disadvantages: