

**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.

<i>Tax w/</i>	Sale Price = $250,000 \div 0.08$	3,125,000
	- Costs of Sale @ 5%	<u>156,250</u>
	Net Sale Price	2,968,750
	- Adjusted Basis	<u>2,158,711</u>
	Total Gain	810,039
	- SL depreciation Claimed.	341,289
	- Gain from appreciation	468,750

Note: Adj. basis = Initial basis - depreciation claimed.

Initial basis	2,500,000
- (35,417 + 3 x 77,273 + 74,053)	<u>341,289</u>
Adj. Basis	2,158,711

- Three different rates may apply at the time of the sale:
  - The *ordinary income tax rate* is used to credit any unamortized loan fees at the time of the sale.

$$\text{Unamortized points} = 20,625$$

$$\text{- Credit at ordinary tax rate (35\%)} \\ \text{- } (20,625) \times 0.35 = (7,219)$$

- The *depreciation recapture rate* (currently 25 percent) applies to the straight line depreciation that was claimed on the property during the holding period.

- This is limited to the amount of the entire gain.

$$\text{- } 341,289 \times 0.25 = 85,322$$

- The long-term *capital gains tax rate* (currently 15 percent in most circumstances) applies to gains that result purely from appreciation of the property (the total gain less straight-line depreciation).

- Note that if the entire gain is due to depreciation recapture, none of the gain is taxed at this rate.

$$468,750 \times 15\% = 70,312$$

Total taxes from sale:

- Unclaimed amort	(7,219)
- Dep. recapture	85,322
- Cap. Gains	<u>70,312</u>
<u>Total</u>	148,415

## 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:

Purchase price	(2,500,000)
+ Mtg.	1,875,000
<u>Fees</u>	<u>(37,500)</u>
Total	662,500

- Up-front  
- Operating  
- Terminal

- We calculated the annual operating cash flows before:

<u>Year</u>	<u>AT</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:

*Real world*

Sale price	3,125,000
- Costs of sale	(156,250)
Net sales price	2,968,750
- Mortgage balance	(1,755,999)
Before-tax equity reversion	1,212,751
- Capital gains taxes at sale	(70,312)
- Depreciation recapture tax	(85,322)
+ Credit for unamortized points	7,219
After-tax equity reversion	1,064,336

*FV w/  
N=54  
= 41.5%*

- 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 51,892.

The IRR of this investment is 17%.

## 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 *Like-Kind exchange.*

- 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:

- *No capital gains taxes today.*
- *If die w/ the new prop. you avoid cap. gains entirely.*

## • Disadvantages:

- *Lower depreciation allowances on the new property.*
- *Strict time limits on completing the exchange.*
- *If the capital gains tax rate will be higher in the future, you are better off paying taxes now.*

