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ADVANTAGE

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Common Real Estate Terms

By Dennis Ayers, CPA, Partner

The field of real estate is a growing and constantly evolving industry. Consequently, owners, investors, developers and others involved in real estate must remain up-to-date in order to structure their transactions in the most beneficial way possible. Following are brief explanations of several of the terms and planning issues that should be considered in today's commercial, industrial and residential markets.

1031 EXCHANGE

What is it? A 1031 exchange allows you to exchange similar kinds of property or investments while deferring the gain from the sale. When property is sold, an accommodator holds the funds until another piece of property is found to buy or "exchange." The gain is only deferred; you will have to pay the tax on it when the next piece of property is sold, unless you keep trading indefinitely. The goal in these transactions is to trade up to property that gives you a better return based on the fair market value of the property sold.

Benefits: Owners who have held property for a long period of time are usually looking at a large gain and therefore a large tax bill. A 1031 exchange allows for a deferral of the gain and the potential to use the appreciated value of the property to acquire property with a higher return.

Pitfalls: The biggest pitfall is finding good replacement property in the time frame allowed – 45 days to identify replacement property and 180 days to close the transaction. The general rule is to plan ahead. When you have an offer to purchase your property, start looking for replacement property; don't wait until the close of the sale!

1033 EXCHANGE ("CONDEMNATION")

What is it? A 1033 exchange is like a 1031 exchange, only better. An involuntary conversion (commonly called a condemnation) of your property can be mandated by a state or local government if the property is designated for use as a park, a school, a road, or for other use deemed by the condemning agency to be beneficial to the public. It is not necessarily based on the property's condition. With a condemnation, you can have up to three years to replace the property by reinvesting the money the government pays you. When you replace it with other property, you are able to defer the gain just like in a 1031 exchange.

"The goal in these transactions is to trade up to property that gives you a better return..."

Benefits: There is an advantage to the 1033 exchange over the 1031 exchange. In a 1031 exchange, if you have debt on the property, you should have equivalent debt on your new property unless you add additional cash in lieu of the debt to complete the exchange. But in a 1033 exchange, there's no requirement to hold the same debt; accordingly, you may pull cash out of the transaction. For example, if you received a sale price of $100,000 for property that was subject to a mortgage of $25,000, you could then purchase replacement property with a purchase price of $100,000 and encumbered by a $75,000 mortgage, thus putting $50,000 in your pocket. In addition, in a 1033 exchange, you hold the initial sales proceeds until you find a replacement property, but in a 1031 exchange these funds must be held by the accommodator.

Pitfalls: Similar to a 1031, the drawback to a 1033 exchange is that it can be difficult to find a replacement property. If you don't find one, your gain goes back to the original year you sold the property, so your tax returns will have to be amended.

TENANTS IN COMMON (TIC)

What is it? Tenants in Common is the holding of property by two or more people where each party has an undivided share in the property as a whole. The owners each report their share of the activity for that property separately; therefore the assets are kept separate from each other. TICs are often used in conjunction with a 1031 exchange.

Benefits: One advantage to using a TIC is that you can trade (1031 exchange) a TIC interest (a partnership interest cannot be traded). There also may be a situation where people, such as family members (brother/sister, mother/son), want to own a TIC property in order to keep their assets separate. TICs also work for business partners who don't want to form a partnership.

Pitfalls: It is vital in this arrangement to ensure that you have appropriate agreements that establish each participant's responsibilities regarding the property. One of the drawbacks to a TIC is that since each party owns their interest, they can legally do whatever they want with it. They could even sell their interest to someone without notifying you. The TIC is designed for people who know what they're doing (and the people they're doing it with!) and understand the risks involved.

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Real Estate Taxation for Owners and Investors

By Kathy Keifner, CPA, Partner

"The hardest thing in the world to understand is the income tax."
Albert Einstein

After seeing the changes in the tax law over my past twenty plus years in public accounting, I might be inclined to agree with Einstein! Let's take a look at some common real estate transactions and the tax treatment of those items.

Personal Residence

The purchase or sale of a personal residence, though common, does not, by any means, mean the income tax laws relating to this transaction are simple! Before making a decision to purchase or sell a personal residence, taxpayers should consider the impact this decision will have on their tax liability.

Certain costs relating to the purchase of a home can be deducted for tax purposes. These costs can include points (a type of prepaid interest), property taxes, and the most substantial of all, mortgage interest. Mortgage interest expense on up to $1 million ($500,000 for married filing separately) of acquisition indebtedness plus up to $100,000 ($50,000 for married filing separately) of home equity indebtedness is fully deductible for regular tax. However, if you later refinance the original loan, the rules on the deductibility of that interest may be impacted. In addition, due to the phase-out rules for itemized deductions and the alternative minimum tax (AMT), these deductions may be limited.

When it comes time to sell a personal residence, a taxpayer can exclude up to $250,000 ($500,000 if married filing jointly) of realized gain from the sale of a principal residence. (Many of you remember the old rules from pre-1997 where you could purchase a new residence that exceeded the sales price of the previous residence to avoid any gain). It is very important that the taxpayer keep a record of all costs related to the purchase of the residence and improvements in order to correctly compute the gain on the sale of the property. The remaining gain after the exclusion is taxed at a maximum long term capital gain rate of 15% for Federal tax purposes. The exclusion cannot be used more than once every two years. Ownership and use issues may also impact the amount of the exclusion.

Real Estate as an Investment

Many taxpayers also invest in rental real estate property. The tax treatment of income or loss from these real estate transactions can be complicated.

Rental real estate has a unique set of rules. Any rental real estate activity is a passive activity and therefore subject to passive loss rules. Income and losses from the passive activities for all properties are netted together. If the net of all the passive activities is income, then the income is treated as ordinary income. If the net of all of the passive activities is a loss, then the losses from all passive activities are subject to the passive loss rules. These rules also determine how the current year's passive income can be allocated against the passive losses.

Deduction of losses is severely limited, and ***any losses not utilized may be carried forward indefinitely to offset future passive activity income.*** Qualifying taxpayers can only deduct up to $25,000 of passive losses from rental real estate activities against nonpassive income. However, this deduction may be reduced based on adjusted gross income. Any non-deducted losses, called "suspended passive losses", can grow over time to a substantial amount for some taxpayers. Upon the sale or disposition of a rental property in a taxable transaction, any suspended passive losses from that activity can be fully deducted in the year of disposition. Suspended passive losses **must** be considered in tax planning and decision making regarding selling a real estate investment.

When a rental property is sold, the tax on the gain may be computed at different rates since it involves the sale of depreciable real property. Most taxpayers are familiar with the long term capital gain tax rate of a maximum of 15%. However, ***many taxpayers focus on the 15% capital gain rate and forget about the higher "Unrecaptured Section 1250 Gain" which is usually applicable to at least part of the gain.*** This gain, ***to the extent of depreciation claimed*** on the property, is taxed at a ***maximum rate of 25%,*** if the real property has been held more than 12 months (if held less than 12 months, ordinary tax rates apply).

These situations point out the importance of tax planning with a professional when managing the timing and terms of the acquisition, disposition, financing and refinancing of your personal residence or investment real estate.

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COST SEGREGATION STUDY

What is it? A cost segregation study is an analysis of a property by an engineer to determine what components of the building would be considered personal property as opposed to real property. Improvements that are attachable to the building but potentially removable can be considered personal property. For example, if you own a building and you put in accent lighting that is theoretically removable, that can be determined to be personal property; in addition the wiring to the lighting can also be considered personal property.

Benefits: The advantage is that personal property assets have a shorter depreciable life and, therefore, you can take the deduction for them over a shorter period. For example, if you spend seven million dollars on improvements, and have a study done which segregates over two million dollars as personal property, then you can expense that amount over 5-7 years instead of 39 years.

Pitfalls: When you sell the property, the depreciation taken on personal property is recaptured at the ordinary income tax rates, instead of at capital gains tax rates. If you're in a higher tax bracket, you're going to pay 35% rather than 15% - that can be a big difference.

LOW INCOME HOUSING TAX CREDITS

These Federal and sometimes state tax credits are for multifamily low income housing projects. Developers can request the credits from the state allocation agency and, if approved, receive ten years of tax credits. The downside is that there is a minimum fifteen-year compliance period during which the building must be maintained as low income housing.

HOW CAN NSBN HELP YOU?

NSBN has expertise in all of these types of transactions. With a Tenants In Common property ("TIC"), we are involved in the accounting, and allocating the activity among the different groups involved. For 1031 and 1033 exchanges, we advise as to the required elements needed to complete the exchange. In addition, if your trade is not completed, we will calculate the tax impact. With cost segregation studies, we review them from a business standpoint to see if they make sense, and file any appropriate tax documents. And for low income housing tax credit projects, we perform the audits that are required, of both the original cost and the ongoing annual audits, as well as the necessary tax returns. Please call us to discuss your individual situation.

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