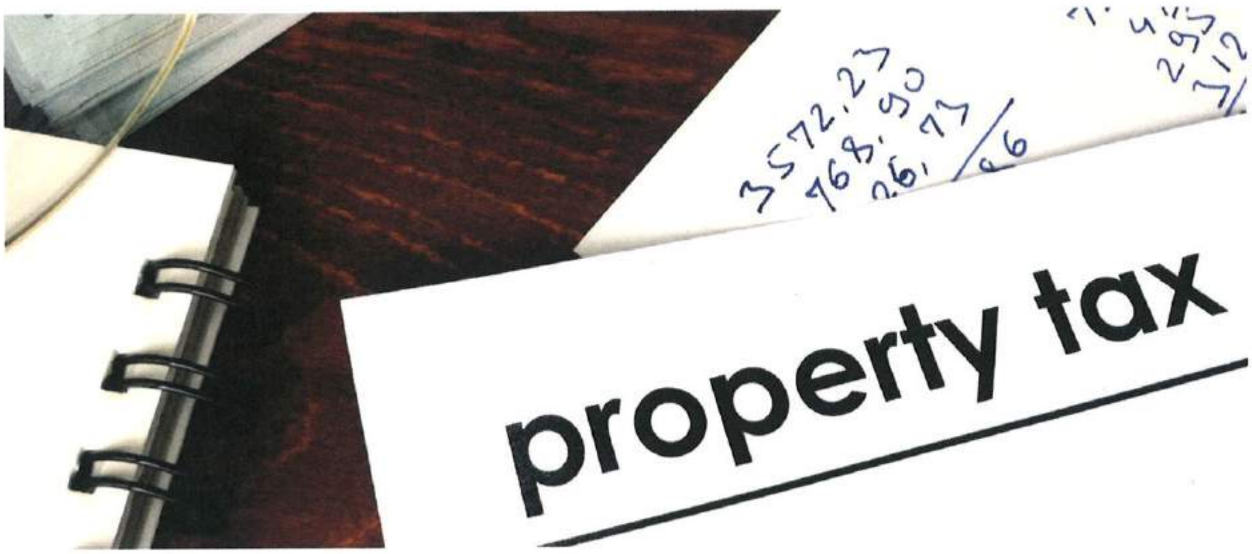
Chapter 11



Taxation of Real Property

Chapter 11 Goals:

- Understand how real estate property taxes are calculated
- Understand numerous tax considerations which relate to homeowners
- Define terms which relate to property taxes (value, assessed value and others)
- Understand important dates which determine homeowner's property tax year
- Learn how to calculate documentary transfer taxes
- Describe provisions for a tax deferred exchange

Chapter 11: Property Taxes

Key Terms

1031 exchange ad valorem adjusted cost basis adjusted gross income assessed value base value basis boot buy up/trade up rule capital asset capital gain capital gains income capital loss certificate of redemption change in ownership statement county assessor deduction delayed exchange depreciation documentary transfer tax entity exemption external obsolescence first-time homebuyer tax credit	federal estate tax functional obsolescence gift gift tax gross income homeowner's exemption income tax inheritance tax installment sale leaseback like-kind Mello-Roos tax mobile home deduction Morgan Property Taxpayer's Bill of Rights observed condition method ordinary income physical deterioration property taxes property tax year Proposition 13 Proposition 60 Proposition 90	reassessment event real property tax assessment sales tax same entity Senior Citizen Property Tax Postponement Program straight-line method special assessment supplemental tax bill taxable income taxes tax bracket tax credit tax deduction tax exemption tax lien tax rate tax withholding Taxpayers' Rights Advocate Office use tax veteran's exemption

Taxes

Taxes refer to the mandatory charges imposed upon taxpayers by the government. Tax revenue circulates money through the economy in the form of social infrastructure and services, including schools (K-12; community college) and emergency services (i.e. police, firefighters, emergency responders).

There are many types of taxes. The government imposes taxes on income, sold goods, and both residential and investment properties.

These taxes – and various exemptions and deductions – will be discussed throughout this chapter.

Income Tax

Income refers to the exchange of a person's time and work for financial compensation.

Most individuals make an income through a salary and/or wages paid by an employer. Individuals over the age of 65 receive the majority of their income from investments, social security, or pensions. Business income refers to the amount a business keeps after calculating profits, losses, and taxes.

Ordinary income refers to any income a taxpayer earns other than capital gains income. This includes, but is not limited to: wages, commissions, tips, corporate profits, collected rent, and bonuses. (**Capital gains income** refers to the income a taxpayer earns from the sale of a capital asset. For example: the sale of a primary residence.)

The income a taxpayer earns is known as **gross income**. A taxpayer's gross income minus specific deductions is known as **adjusted gross income.**

A taxpayer's adjusted gross income minus any exemptions is known as **taxable income**. This is the income on which a taxpayer will be taxed.

An **income tax** is a levy imposed on taxpayers – both individuals and entities – based on their respective income or profits. Federal, state, and local governments impose income taxes.

Residents who have been residing in California for more than one year and meet the minimum income requirements are required to pay state income taxes. Individuals who have not lived in California for more than a year but have income originating in the state of California must file a nonresident tax return or part-year residence tax return.

Tax Rate

Income tax rates vary based on a variety of factors, including the fiscal goals of the President and Congress, economic growth projections, and the fiscal needs of a county or state.

In periods of slow economic growth, governments may reduce taxes in order to incentivize financial investment in the economy. Conversely, the government may increase taxes in times where there is a high debt deficit.

A taxpayer's tax bracket determines his or her tax rate. A **tax bracket** refers to the division of tax rates based on taxable income level.

Generally, the higher a taxpayer's income is, the higher his or her tax rate. However, taxpayers with similar income levels are not necessarily subject to the same tax rate.

Tax rates differ based on a taxpayer's primary source of income (i.e. self-employed, wages, investments).

For example, self-employed taxpayers may be able to itemize tax deductions and reduce their overall tax liability, whereas wage earners cannot. Taxes also differ for those whose primary income comes from investments, including stocks and real estate.

The **Morgan Property Taxpayer's Bill of Rights** was enacted in 1994 to protect property owners' right to a full and accurate disclosure of their property taxes. The Act ensures that taxpayers have the ability to understand how their taxes are determined, including the tax rate used.

Tax Credits

A **tax credit** provides a dollar-for dollar reduction of a taxpayer's income tax liability. For example, a $1,000 tax credit saves a taxpayer $1,000 in taxes.

Tax credits cannot reduce a taxpayer's income tax liability to less than zero, however.

Tax Exemptions

A taxpayer may qualify for certain exemptions on his or her taxes based on his or her financial and marital status. The following questions help determine which income tax exemptions apply:

- Is the income earner self-employed or a wage earner?
- Is the income earner single or married?
- If married, does the couple file jointly or separately?
- If a married couple files jointly, does the income earner's spouse earn an income?
- Are there any dependent children?

Tax Deductions

Not all income is taxable. A **tax deduction** refers to a tax-exempt expense on an individual's tax return. Unlike a tax credit – which reduces the tax paid by a taxpayer – tax deductions lower a taxpayer's taxable income.

For example, an individual who is liable for child support payments will not be taxed on income that goes towards those payments. Generally, income that is saved in retirement accounts – such as 401Ks or other long-term investments – are also not taxable.

These deductions are equivalent to the percentage of a taxpayer's tax bracket.

For example, if a taxpayer is in the 25% tax bracket, a $1,000 deduction will save the taxpayer $250 in taxes (0.25 x $1,000 = $250).

Once a taxpayer determines the tax bracket under which he or she falls, the taxpayer can decide whether it is in his or her best financial interests to use a standard deduction form or to itemize his or her deductions separately (if applicable).

A tax deferred exchange

Home Purchase Deductions

Property owners can obtain an exemption from federal income taxes on the sale of a primary residence.

In order to qualify, a property owner must live in his or her house as a primary residence for at least two of the previous five years.

The exemption amount is $250,000 for unmarried individuals and $500,000 for married individuals. This means that if an individual seller makes a profit of $250,000 or less on the sale of his or her home, the seller will not be taxed on that profit.

Example

Question: Margarita has owned her home for over three years. After seeing the real estate market improve dramatically over this period, Margarita believes that it's a good time to sell her home for a profit. She originally bought her home for $505,000. Based on comparables in her area, she believes her home is now valued at $750,000. If the home sells for $750,000, will Margarita have to pay federal income tax on the profit she makes on the house?

Answer: *No. Because Margarita's profit is below $250,000 the (maximum write-off for unmarried individuals), she is not liable to pay property taxes on the income from the sale.*

A taxpayer can also write off some of the costs associated with purchasing a property on the Schedule-A section of his or her tax return. The amount that a taxpayer can deduct depends on his or her filing status, taxable income amount, how he or she files for deductions, and the deduction amount.

Recurring costs (i.e. property insurance, homeowner's association fees) are not tax-deductible.

Nonrecurring, one-time costs are tax-deductible. These costs include:

- Credit report fee
- Appraisal fee
- Title insurance fee
- Escrow fee
- Inspection fees
- Notary fees
- Recording fee
- Expenses prorated to the seller
- Loan origination fees / lender points

Manufactured or Mobile Home Deduction

Manufactured or mobile homes built after 1989 are only taxed on 75% of the property's total sale price.

Mortgage Deductions

Mortgage deductions make the cost of homeownership more affordable. In some cases, they are the difference between an individual being able to own a home or not.

The following mortgage-related expenses can be deducted on a property owner's income taxes:

- Mortgage payments on first and second loans
- Mortgage insurance premiums*
- Mortgage interest on a loan below $1 million for a primary residence that is secured by real estate as collateral

**At the height of the real estate crisis, Congress passed the Mortgage Forgiveness Act of 2007. The Act allowed borrowers to deduct private mortgage insurance from their taxes. Congress ended this deduction on December 31, 2010 after the economy had begun to improve.*

Tax Brackets and Rates, 2018

Rate	For Unmarried Individuals, Taxable Income Over	For Married Individuals Filing Joint Returns, Taxable Income Over	For Heads of Households, Taxable Income Over
10%	$0	$0	$0
12%	$9,525	$19,050	$13,600
22%	$38,700	$77,400	$51,800
24%	$82,500	$165,000	$82,500
32%	$157,500	$315,000	$157,500
35%	$200,000	$400,000	$200,000
37%	$500,000	$600,000	$500,000

Tax Withholding

When a property is sold in California, the state requires a certain amount to be withheld. Real estate withholding is not an additional tax on the sale, but rather, a prepayment of the income tax due on the capital gain of the sale.

The standard amount of withheld income taxes is equal to 3.33% of a property's sale price. A buyer must pay this amount to the California Franchise Tax Board.

Certain real estate transactions are considered exceptions to withholding, including:

- Real estate transactions of $100,000 or less
- Property is a seller's primary residence
- Property is sold at a capital loss or zero gain
- The seller is a certified exemption, such as:
    - Corporations
    - Partnerships
    - LLCs in a partnership
    - Tax-exempt entities (i.e. religious, charitable organizations, nonprofit educational facilities, healthcare facilities)
    - Insurance companies
    - Individual retirement accounts (IRAs)
    - Charitable trust
    - Qualified pensions

To claim an exemption, a seller must complete Form 593-C, the Real Estate Withholding Certificate.

Sales Taxes

A **sales tax** is a tax for buying and selling products or services. Sales tax is typically paid directly by a consumer, although a business can include sales tax in the final price of its product or service. Almost everything that is bought or sold is subject to sales tax.

Items that are considered "necessary" are exempt from sales tax. For example, most food is not taxed. (Food at restaurants may be taxed because a business prepares the food for a consumer and that preparation is considered a "non-necessity".)

The Board of Equalization administers sales taxes in California.

As of January 1, 2017, the minimum sales tax rate in California is 7.25%. Many cities impose additional taxes beyond the standard rate to compensate for the increased cost of providing basic services and maintenance to residents.

The sales tax rates in California's largest cities are:

- Los Angeles: 9.00%
- Oakland: 9.5%
- Palo Alto: 8.63%
- Sacramento: 8.00%
- San Diego: 8.00%
- San Francisco: 8.75%

The sale of used manufactured or mobile homes is not subject to sales tax. However, the owner must still pay property taxes. Owners are responsible for paying property taxes to the state in which the vehicle is primarily located.

Use Tax

A **use tax** is a tax imposed on items purchased online, from an auction, or from another state in which the consumer did not initially pay sales tax.

A use tax is either paid directly by a consumer or included in a seller's final sale price. Like sales tax, a use tax is not applied to items that are deemed "necessary" (i.e. food, medication).

California's Board of Equalization administers use taxes.

Property Taxes

California collects property taxes based on the **ad valorem** system. This means that property taxes are based on the assessed value of a property.

Property taxes are at the cornerstone of local tax revenue.

Before 1912, nearly 70% of California's tax revenue was collected through property taxes. However, this inhibited consumers' ability to own a home. California therefore reversed this trend and began collecting taxes primarily from consumers' personal income. This led to an unprecedented upswing in economic growth in the state.

As property values generally increase over time, so do property taxes. As of 2011, nearly $40 billion a year is contributed through property taxes.

Local governments are responsible for property tax collection and balancing property tax rates. They must collect enough revenue to support a community, but not make taxes so high that new buyers do not buy in the community.

Property Tax Legislation

Proposition 13

In the 1970s, local California counties had their own individual tax rates. A property owner's total property tax rate was a composite of these individual rates. This system led to higher overall property taxes.

Proposition 13 was passed in 1978 in response to public outcry. **Proposition 13** amended California's Constitution to return property tax rates to 1975 levels and to limit rate increases.

The main provisions of Proposition 13 are:

- A maximum property tax base value of 1% (in addition to any approved special or benefit assessment taxes)
- Annual property tax increases capped at 2%

Prior to the passage of Proposition 13, property taxes were updated approximately every five years. Under Proposition 13, property taxes are only reassessed after a property is sold or undergoes major renovations.

A property owner can also transfer a property title to a spouse or a family member without a tax reassessment.

Homeowners who have owned their homes for a long period of time typically have lower property taxes. New buyers generally have higher property taxes as their property's value is assessed more recently. For this reason, a property owner's tax bill can be completely different than his or her neighbor's.

Proponents of Proposition 13 cited it as a victory for seniors who would be protected from property tax increases that could force them from their homes.

However, Proposition 13 led some counties to experience fiscal crises. As fewer taxes were being collected, counties were forced to cut their budgets. This left many local governments with sizeable budget deficits. In response, California passed small bailouts for the most affected counties and municipalities to offset their net property tax losses.

Mello-Roos Tax

To further offset the effects of Proposition 13, the Mello-Roos tax was created.

A **Mello-Roos tax** is a temporary parcel tax that is levied in addition to the standard property tax rate. It circumvents Proposition 13 by charging a flat tax on a parcel of real property, rather than charging a tax based on the assessed value of real property.

The creators of the Mello-Roos tax – California state senator, Henry Mello, and state assemblyman, Mike Roos – argued that local governments were struggling to generate enough tax revenue under Proposition 13. They created the Mello-Roos tax so that cities could generate adequate funds for vital social services, including schools, road maintenance, libraries, police and fire departments.

In order to impose a Mello-Roos tax, the state assembly must vote on the measure and pass it by a two-thirds majority.

The Mello-Roos tax is not a permanent tax. It remains in effect until the principal and interest of the local and state programs being financed are paid off. However, this can take up to 40 years.

In the event that a property owner subject to a Mello-Roos tax wishes to sell his or her property, the property owner must disclose the presence of the Mello-Roos tax to a prospective buyer.

Special Assessment

A **special assessment** – also known as a benefit assessment – is a tax levied by the government on parcels of real estate in a particular area.

A special assessment tax is implemented in order to generate funding for public projects, such as roads, street lighting, sidewalks, sewage, or flood protection measures.

Such a tax is only levied on property owners who directly benefit from the services being funded through the tax.

Special assessments may be effective for a single tax period or remain in place indefinitely.

A local government must approve a special assessment tax by a two-thirds margin.

A special assessment may be funded with bonds issued by a locality.

Proposition 60 & 90

Proposition 60 allows senior citizen homeowners (55 years or older) to transfer their original residence's property tax bill to the purchase of a new residence. This gives senior citizens the ability to downsize without risking an increase in property taxes.

Proposition 90 extends the provisions of Proposition 60 by allowing a property tax bill to be transferred to any county that accepts the tax bill transfer. This allows a senior citizen or disabled homeowner to downsize to a new property outside of the county where the original property was located.

Real Property Tax Assessment

A **real property tax assessment** refers to when the government evaluates a property to determine its current market value. The state will evaluate a property based on its location, size, and condition.

A property's value is reassessed whenever a property is sold or when the value of the property increases significantly, such as a major renovation. The event that causes a property reassessment is known as a **reassessment event**.

Example

Question: Susan renovates her property and adds approximately 800 square feet. Each square foot in her neighborhood is valued at $295. Therefore, Susan has increased the value of her property by $236,000 ($295 x 800). Is Susan responsible for paying property taxes on the new value?

Answer: *No. Because Susan is the current homeowner, the property taxes will not be reassessed and her property taxes will remain the same. If her home is sold, however, the new property owner will be required to pay property taxes on the new property value. Although the value of the property will be increased dramatically, she still will not be liable for the increased property taxes.*

If a property is sold or transferred, the new property owner must file a **change in ownership statement** within 45 days of the sale/transfer.

A renovation implemented to meet the needs of a disabled homeowner – such as an elevator, special staircase, or bathtub – does not count as a reassessment event.

The government uses a property's **base value**, or cash value, to begin its assessment. The **county assessor** subsequently compares the property to recently sold properties ("comparables") to determine the **assessed value**.

The following rules apply when determining a property's assessed and base value:

- If a property had no changes (i.e. ownership transfers, renovations) since February 28, 1975, the assessed value is equivalent to the base value*.
- If a property was sold after February 28, 1975, the assessed value is equivalent to the base value of the property as of the date of the sale*
- If a property was constructed after February 28, 1975, the assessed value is equivalent to the base value after the completed construction*
- If a property was improved after February 28, 1975, then the assessed value is equivalent to the base value plus the sum of the new home improvements*

**plus a maximum annual inflation rate of 2%*

On average, the assessed value is usually lower than the appraised value.

Property taxes are altered based on a property's newly assessed value. If the property's value has gone up, property taxes will increase; if the property has lost value, property taxes will decrease.

After a property's value it reassessed, the property owner will receive a supplemental tax bill. A **supplemental tax bill** is the difference between the old tax rate and the reassessed tax rate.

As county assessors deal with many files, it is common for them to make mistakes. Therefore, a county tax assessment can be appealed within 60 days of receiving a supplemental tax notice.

A property owner must be prepared to present proof as to why the new property taxes are too high. First, a property owner should compile a list of recently sold comparables to showcase neighborhood property values. If applicable, a property owner should also list any damages to the property and the cost of repairs. A property owner must then compare this information to the county's assessment.

Sample Property Tax Bill

PARCEL NUMBER	BILL NUMBER		PROPERTY LOCATION
000-0000-000-0000		Parcel number	

SACRAMENTO COUNTY
SECURED PROPERTY TAX BILL 2011-2012
FOR FISCAL YEAR BEGINNING JULY 1, 2011 AND ENDING JUNE 30, 2012

ANNUAL TAX BILL

JULIE VALVERDE
DIRECTOR OF FINANCE
TAX COLLECTOR

*** ATTENTION ***

IMPORTANT INFORMATION ON REVERSE SIDE

MAIL TO:

JANUARY 1, 2011, LIEN DATE ASSESSED VALUES	
LAND	46,858
IMPROVEMENTS	93,407
FIXTURES	
PERSONAL PROPERTY	
ASSESSED VALUES SUBTOTAL	140,265
LESS: HOMEOWNERS EXEMPTION	7,000
OTHER EXEMPTION	
NET ASSESSED VALUES	133,265

TAX RATE AREA CODE

AD VALOREM TAXING AGENCY	TAX BASE	TAX RATE	TAX AMOUNT
COUNTY WIDE 1%	1	1.00000	1,332.65
LOS RIOS COLL GOB	1	.01920	25.59
AD VALOREM TAXING AGENCY TOTAL			1,358.24

Generally deductible

LEVY #	STATUTORY AUTHORITY	DIRECT LEVY NAME	PHONE NUMBER	LEVY AMOUNT
0254	L & L ACT 1972	COSUMNES CSD - DIST. WIDE L & L	800-273-5167	238.76
0155	MELLO-ROOS	ELK GROVE SCHOOL DIST MR - CFD #1	916-686-7562	117.84
0016	1982 ACT	STREET LIGHTING MAINT DISTRICT #1	916-627-3205	17.88
0443	WC 51335	WATER & DRAINAGE STUDIES - SCWA 13	916-874-7139	6.92

Generally nondeductible

DIRECT LEVY TOTAL	381.40
ADJUSTMENT TO MAKE BILL EVEN	

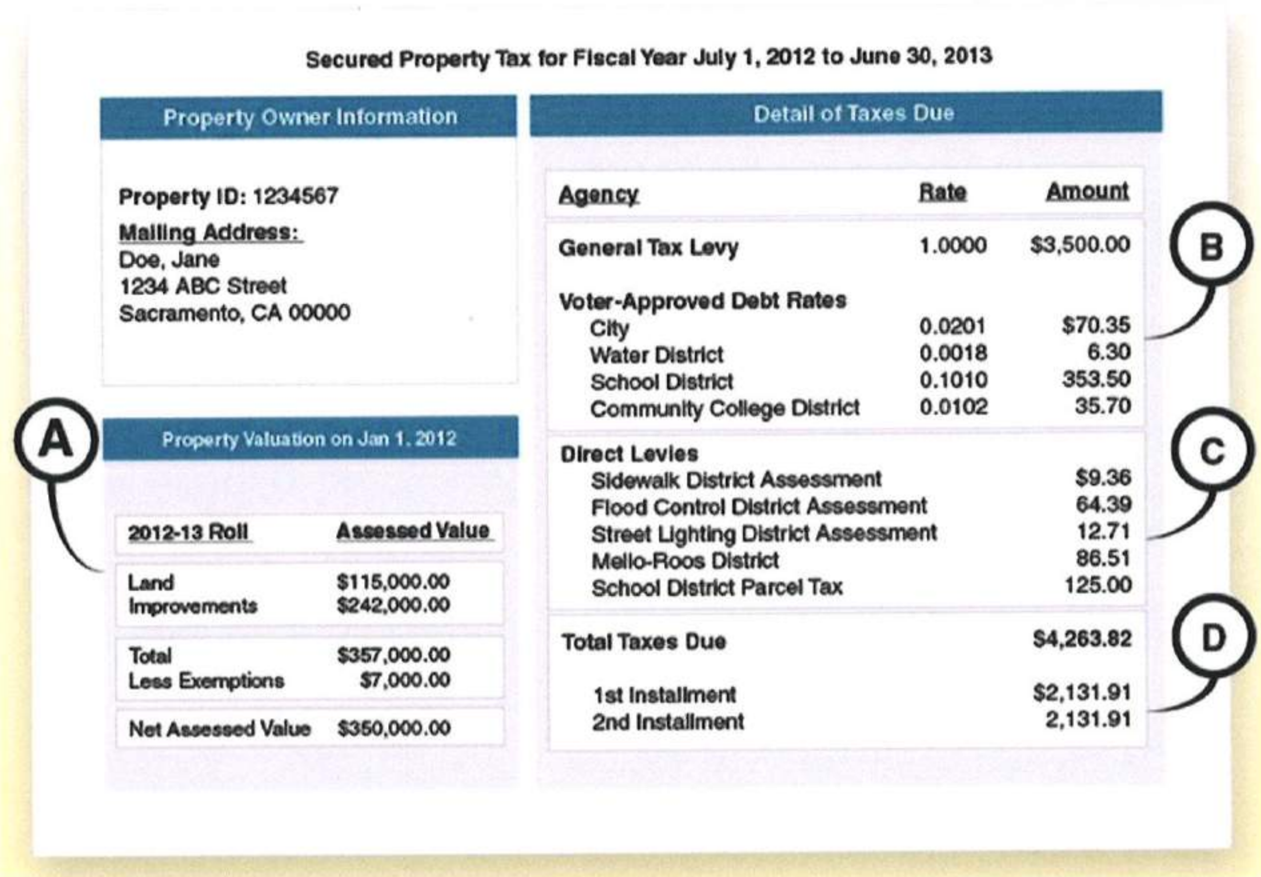
Note from FTB:

This is a sample tax bill. It is not an all-inclusive list of what is deductible and nondeductible. Based on this sample tax bill:

-The green highlight indicates a tax rate. The presence of a tax rate indicates the corresponding amount is generally deductible.

-An amount that does not include a corresponding tax rate is generally nondeductible.

For more information, go to **ftb.ca.gov** and search for **real estate tax**.



Secured Property Tax for Fiscal Year July 1, 2012 to June 30, 2013

Property Owner Information

Property ID: 1234567
Mailing Address:
Doe, Jane
1234 ABC Street
Sacramento, CA 00000

Property Valuation on Jan 1, 2012

2012-13 Roll	Assessed Value
Land	$115,000.00
Improvements	$242,000.00
Total	$357,000.00
Less Exemptions	$7,000.00
Net Assessed Value	$350,000.00

Detail of Taxes Due

Agency	Rate	Amount
General Tax Levy	1.0000	$3,500.00
Voter-Approved Debt Rates		
City	0.0201	$70.35
Water District	0.0018	6.30
School District	0.1010	353.50
Community College District	0.0102	35.70
Direct Levies		
Sidewalk District Assessment		$9.36
Flood Control District Assessment		64.39
Street Lighting District Assessment		12.71
Mello-Roos District		86.51
School District Parcel Tax		125.00
Total Taxes Due		$4,263.82
1st Installment		$2,131.91
2nd Installment		2,131.91

Property Tax Year

The **property tax year** begins on July 1st and ends on June 30th of the following year.

Property taxes are divided into two equal payments. The first payment is due on November 1st; the second is due on February 1st.

The first payment can be paid without penalty until December 10th. The second payment can be paid without penalty until April 10th.

Should a property owner fail to make property tax payments on time, a 10% penalty will be imposed. If a property owner continues to default on payments, he or she risks a tax lien and/or foreclosure.

Tax Liens

A **tax lien** is an involuntary lien resulting from a property owner being behind on property taxes for a significant period of time. Tax liens hold seniority over all other liens regardless of the loan amount or the date another loan was initiated.

A tax lien must be filed with the recorder's office in the county in which a property is located. The state may also enforce penalties, interest, and other fees that will raise a property tax bill.

Designated officials will work with a property owner to help him or her avoid foreclosure through the establishment of a payment plan. Common payment plans include paying monthly taxes, making quarterly payment installments, and breaking up the delinquent taxes into several payment portions.

If a property owner becomes current on all unpaid taxes, the county tax office will issue a **certificate of redemption**.

If unpaid taxes are not brought current, however, a property will go into foreclosure.

After foreclosure, a property may be acquired by a nonprofit organization or sold at a public auction. If it is acquired by a nonprofit organization, a property will be categorized as low-income housing.

If a property is to be sold at a public auction, the county tax collector will issue a tax deed to the state. This grants the state the legal right to sell the property at a public auction. The winning bidder pays the property's unpaid property taxes and is issued the tax deed.

Should a taxpayer believe that he or she has been unfairly taxed, the taxpayer can contact the **Taxpayers' Rights Advocate Office**. The Advocate's Office handles complaints and problems that taxpayers cannot solve on their own, such as when a taxpayer faces financial difficulties that prevents the payment of property taxes or when a taxpayer faces an immediate action leveled by the IRS.

Property Transfer Taxes

Federal Estate Tax

A **federal estate tax** is a tax levied on the value of a deceased individual's estate prior to it being distributed to the individual's designated heirs. Estate refers to real property, cash, securities, joint ventures, insurance, annuities, and any other assets.

The government uses an estate's current market value to determine the tax rate for the transfer, rather than its originally assessed price. Deductions on the federal estate tax include mortgages and the costs associated with organizing and managing the estate.

The Economic Growth and Tax Relief Conciliation Act of 2001 eliminated the federal estate tax for most taxpayers. As of 2017, the federal estate tax only applies to individuals with estates valued at $5.49 million or more.

Estates with a net worth of more than $1.5 million must pay for the increased taxes. While all income is taxable, estate's below $1.5 million are not responsible to pay the estate tax. Any unpaid estate taxes must be brought current within nine months of an estate holder's death. Payments made after nine months will be subject to a penalty of 5% the tax value per month.

If unpaid estate taxes are not brought current, an estate tax lien will be implemented. Estate tax liens are not recorded, but they still apply to future homebuyers of an encumbered property.

Inheritance Tax

An **inheritance tax** – more commonly known as a death tax – is a tax levied on an estate holder's assets that is paid for by the estate holder's heir.

For example, say a state charges a 3% inheritance tax on any inherited assets. If an heir is bequeathed a sum of $2 million, the heir will have to pay $60,000 in inheritance taxes on the sum.

The federal government does not impose an inheritance tax.

California ended the state inheritance tax in 1981 with the repeal voted on by voter's.

Gift Tax

If a property owner transfers – or "gifts" – a property or assets to another individual without being paid for them, the property owner is liable to pay a **gift tax**. A **gift** is technically defined as transferring a property with a 0% interest rate loan or selling a property for below market value.

Certain transfers are not subject to a gift tax. For example: transferring money for education or medical bills.

A gift tax must be claimed by April 15th of the year following the year the gift was given.

Every citizen can claim a $14,000 annual exemption from the federal gift tax. Gifts are only taxed when their total value exceeds what a citizen is permitted to give away during the course of his or her lifetime (over $5 million as of 2017).

Proposition 6 revoked the California government's ability to impose a gift tax.

Documentary Transfer Tax

A **documentary transfer tax** occurs each time a property is recorded. The state charges $.55 for every $500 of a property's value, minus any loans assumed by the buyer.

A documentary transfer tax is paid upon a property's transfer. Depending on negotiations, it can be paid by a buyer, a seller, or by both parties.

The transfer of a property between family members is not subject to a documentary transfer tax as such a transfer is considered a "gift".

Example

Question: Sam wishes to buy a property on Almont Avenue that is being sold for $925,000. Sam assumes a first loan of $495,000 and pays the remaining $430,000 as a down payment. What is the documentary transfer tax due?

Answer: *To calculate the documentary transfer tax, Sam must determine the amount paid without a loan ($430,000). He then divides that amount by $500 and multiplies that amount by .55.*

$430,000/$500 = $860

$860 (.55) = $473 transfer tax

Property Tax Credits

First-Time Homebuyer Tax Credit

The American Recovery and Investment Act of 2009 (ARRA) provided first-time homebuyers who purchased a primary residence between the years of 2008 and 2010 with an $8,000 tax credit.

The Act also provided a tax credit of $6,500 for second or third time homebuyers who lived in their primary residence for five consecutive years.

Program eligibility changes depending on the year. However, the general qualifying criteria is as follows:

- Applicant must be a first-time homebuyer

- Applicant must have bought or entered into a purchase contract on, or before, April 30, 2010. The deadline for military personnel is April 30, 2011.
- If applicant entered into a purchase contract before April 30, 2010, the transaction must have been finalized and closed escrow on, or before, September 30, 2010.

To apply for the tax credit, a seller must complete Form 5405 – First Time Homebuyer Credit and Repayment of the Credit.

This tax credit must be paid back within 15 years of the home's purchase. If a purchased property is eligible for the credit and is sold within one year, the homeowner must pay back the tax credit using the profits generated from the sale.

Property Tax Exemptions

Entity Exemptions

Certain entities are exempt from property taxes, including:

- Religious organizations
- Charitable organizations
- Nonprofit educational facilities
- Healthcare facilities (i.e. hospitals, clinics)

Homeowner's Exemption

A **homeowner's exemption** awards a tax break of up to $7,000 to the owner of a primary residence. In other words, an eligible property owner's property taxes are based on a property's assessed value minus $7,000.

To receive the maximum $7,000 homeowner's exemption, a property owner must file before February 15th of a tax year. If a property owner files after February 15th, he or she can only receive up to 80% of exemption ($5,600).

The current property tax rate in California is 1%, expressed as 0.1% in calculations.

Example

Question: Gloria and Floyd have owned their principal residence since 1980. When they originally purchased the property, it was assessed at $78,000. As a married coupled, they qualify for the maximum homeowner's exemption of $7,000. The couple's property was subject to the standard 2% annual property tax increase. The assessed value of Gloria and Floyd's property today is $344,000. Based on this, what do they pay annually in property taxes?

Answer:

Assessor's Estimated Value:	*$344,000*
Homeowner's Exemption:	*$7,000*
Taxable Amount:	*$337,000*
Tax Rate:	*0.1%*
Total Property Taxes	*$3,700*

Veteran's Exemption

A **veteran's exemption** provides an eligible veteran with reduced property tax rates in exchange for his or her service. Such an exemption awards a tax break of up to $4,000 of the assessed value of a property.

In order to qualify:

- A single veteran must own a property valued at $5,000 or less
- A married couple or the unmarried surviving spouse of a deceased veteran must own a property valued at $10,000 or less

Disabled veterans are entitled to additional exemptions. A disabled veteran can qualify for an exemption of up to $115,060, or up to $172,592 if his or her income is below $51,669 a year.

Property Tax Postponements & Deferrals

Senior Citizen Property Tax Postponement Program

The **Senior Citizen Property Tax Postponement Program** was created to allow senior citizens (62 years or older) and disabled individuals who were in danger of foreclosure to postpone paying property taxes.

An individual must have at least 20% equity in the property to qualify.

Individuals claiming such an exemption will be subject to a tax lien. This allows the state to recover unpaid property taxes if:

- The property is sold
- The property owner dies
- The property owner is no longer eligible through an increase in income
- The property owner defaults on a special tax assessment

The government suspended the program in February 2009. However, certain counties may still extend the program to county residents.

Delayed Exchange

A **delayed exchange** refers to when a property owner ("exchanger") terminates his or her ownership of a property before he or she acquires new property.

A delayed exchange is the most common type of tax-deferred exchange.

Exchangers have up to 180 days to exchange a property, but they must submit three potential replacement properties within 45 days. The potential replacement properties cannot exceed 200% of the market value of the relinquished property.

Due to the detailed nature of legal codes and tax codes, an exchanger must use an intermediary to implement the simultaneous sale and purchase of real property.

Related Party Exchange

A related party exchange refers to the exchange of real property between family members or entities that have a pre-existing relationship. A related party can be any of the following:

- Family members (i.e. brother, sister, spouse, grandmother)
- Parties of a trust
- Two corporations controlled by the same group
- Partnerships with 50% or more common ownership

According to IRC Section 1031 (f), two related parties that own separate properties can swap properties and defer taxes on the gain if both parties hold their new properties for two years or more following the exchange.

This two-year rule was created to prevent parties from using a related party exchange to avoid paying taxes on the sale of a property.

Investment Properties

A real estate investor refers to an individual or a group of individuals who purchase real estate for its income potential, rather than as a residence. An investor may buy a property to renovate and resell it at a higher value or to obtain rental income.

As investment properties are not owner-occupied, investors are not eligible for the existing federal tax credits for homeownership. However, there are other provisions that can reduce an investor's overall tax liability.

Capital Investment

Basis is used in order to determine the accurate capital gains or losses resulting from the purchase or sale of a capital asset.

Capital Asset: Any purchased asset that directly contributes to and/or grows a business' operations. An asset that is purchased to be sold as inventory does not qualify as a capital asset.

For example, a company may purchase technology with the purpose of using it to grow its business. In this case, the technology is a capital asset. If a different company purchases the same technology with the goal of selling it, it is not considered a capital asset, but rather, inventory.

The most common capital asset is a rental income-producing property.

Capital Gain: The amount gained after comparing the cost of a capital asset to its sale price. Capital gains are taxed at 10% or a higher rate and are calculated after an asset is sold. Business expenses and improvements to a property can be deducted from a taxpayer's recognized gain and lower his or her tax liability.

Capital Loss: The amount lost after comparing the cost of a capital asset to its sale price. These losses can reduce a taxpayer's taxable income.

Investment Property Deductions

An investor can reduce the cost of owning a rental income-producing property through certain deductions.

Qualified deductions include:

- Depreciation
- Property management fees
- Local transportation expenses
- Legal and other professional fees
- Cleaning fees
- Maintenance and repair fees
- Improvements and renovations
- Advertising fees
- Rental payments
- Utilities
- Property Taxes
- Mortgage insurance premiums

Deductions only apply to the portion of a property being used to generate rental income.

A real estate investor can deduct up to $25,000 of losses if he or she earns less than $100,000 per year. Losses include vacant units, below market rental rates, and other similar instances.

Depreciation

Depreciation refers to the natural process of a property reducing in value. It is considered a capital loss. As mentioned above, depreciation can be deducted from an investor's tax return to lower his or her tax liability.

An investor is able to claim depreciation on a property if:

- He or she owns the property
- The property is used for rental income-producing purposes
- He or she will retain property ownership for longer than one year
- The property has a determinable useful life. This means it must be something that wears out, decays, gets used up, becomes obsolete, or loses its value from natural causes.

Depreciation is determined by taking into account the following:

- Basis
- Land value vs. building value
- Recovery period
- Deductions
- Adjusted cost basis

Basis

Section 1012 of the IRS tax code defines **basis** as "the cost for acquiring property". This refers to the net cost of purchasing an asset after adjustments.

Adjustments that are included in the basis are:

- Legal fees
- Recording fees
- Transfer taxes
- Title/escrow fees
- Agent/broker commissions
- Surveys
- Abstract fees
- Any amount a seller owes that a buyer agree to pay (i.e. unpaid property taxes)

In the event that a buyer pays for a seller's unpaid property taxes when purchasing a property, the buyer cannot claim those property taxes as a deduction.

Adjustments that are <u>not</u> included in the basis are:

- Lender points
- Mortgage insurance premiums
- Loan origination fees
- Credit report costs
- Appraisal fees
- Losses

For example, a buyer purchases a home for $320,000. The buyer spends $19,200 in qualified adjustments to close the transaction. Therefore, the buyer's basis is $300,800.

Land Value vs. Building Value

Almost all rental income-producing properties qualify for depreciation.

The one exception is land without any structures. Depreciation is based on the natural process of a property depreciating; a taxpayer cannot claim depreciation on land because land itself doesn't depreciate beyond environmentally induced changes.

Therefore, a taxpayer must separate out the value of a property's land and the value of the rental income-producing building on a property. The value of the building will be used to determine depreciation.

Recovery Period

Depreciation begins as soon as a property is rented out and begins generating income. Depreciation stops when a property owner has recovered the basis or when a property is no longer used for business purposes. (A vacant rental property can still be used to claim depreciation.)

Adjusted Cost Basis

An **adjusted cost basis** refers to a property's original basis plus any increases or decreases that occur in between a property being purchased and a property being rented. These changes are typically due to business expenses and improvements.

For example, an apartment building's basis may be increased if the property owner conducts floor-to-ceiling renovations prior to acquiring its first tenants.

Depreciation Methods

There are two methods used to calculate depreciation:

- Straight-line method
- Observed condition method

Straight-Line Method

The **straight-line method** – also known as declining balance method – involves dividing the value of a property by its expected lifespan in years. This method calculates the annual decrease in a property's value.

The expected lifespan for residential real estate owned after 1987 is 27.5 years. The lifespan for commercial real estate is 39 years. However, the rate of depreciation may decrease with good maintenance, repairs, and upkeep.

Example

Question: A clothing manufacturing company purchases a factory for $600,000. The factory's economic lifespan is projected at 50 years. However, the property is already 25 years old. How much will the factory depreciate over the next 25 years?

Answer: *Dividing the factory's value by its lifespan, then multiplying that figure by 25 years determines the amount of depreciation.*

$600,000 /
50 years
= $12,000 annual depreciation

$12,000 x

25 years

= $300,000 total depreciation

Observed Condition Method

The **observed condition method** calculates depreciation by computing a property's physical deterioration, functional obsolescence, and external obsolescence.

Physical deterioration refers to a property's natural deterioration from damage, wear and tear, and/or old age. For example: heavy rain that ruins a property's roof or the gradual decline in quality of a property's wood floors. Depending on the extent of the damage, physical deterioration may either be curable or incurable.

The word "obsolescence" derives from the word "obsolete", which refers to something being outdated or irrelevant. **Functional obsolescence** refers to a reduction in a property's value after the property falls out of line with typical community standards.

For example, a property's usefulness may be reduced as a result of an outdated home style. This often occurs when a long-time property owner makes no updates to his or her property.

Another example of functional obsolescence is a gas station. Per California law, any buyer of an old gas station must remove all underground tanks and wait a period of one to two years before he or she convers it into another business or other purpose. Consequently, the value of the gas station is dramatically reduced to compensate for the additional costs and time incurred to make the property useful.

Conversely, **external obsolescence** refers to a reduction in a property's value due to external, non-curable causes. External causes that may cause depreciation include zoning ordinances, new development projects, population growth, inflation/deflation, and the financial market.

For example, say a large company in town relocates its headquarters to a new state. A large number of the company's employees sell their homes at the same time to relocate with the company. The sudden influx of real estate inventory on the market creates a higher supply than demand and depreciates other property values in the area.

With many factors to calculate and varying prices, this method creates a sizeable margin of error. As a result, appraisers rarely use this method.

Example

The reproduction of a building costs $920,000. The following would be used to calculate its depreciation over this period:

Physical Deterioration

Curable:	$92,000
Incurable	$53,000

Functional Obsolescence

Curable	$39,000
Incurable	$2,000

External Obsolescence

Curable	$0
Incurable	$0
Total:	$186,000

Investment Property Tax Deferrals

There are several ways in which investors can defer property taxes on an investment property, including:

- 1031 exchange
- Installment sale
- Leaseback

1031 Exchange

As property values rise, property owners gain equity. However, this means that a property will be taxed at a higher capital gains tax rate if it is sold. This makes many property owners reluctant to sell their properties, which inhibits economic activity.

1031 exchanges were created to encourage real estate sales and bolster economic activity.

A **1031 exchange** is a federal tax provision that allows investors to defer paying capital gains taxes on the profit of an investment property sale if they reinvest those gains into the purchase a new property. Such an exchange does not eliminate capital gains taxes from a property sale; it only defers them.

Only investment properties qualify for 1031 exchanges. Taxpayers cannot use tax-deferred exchanges for primary residences.

In addition, a seller must buy a like-kind property. Properties are **like-kind** when they fall under the same category, class, or purpose, and they share the "same nature or character." This applies even if the quality and build of the properties are different.

The value of a replacement property must be the same or higher than the original property. In other words, all of the profit from the sale of the original property must be used for the purchase of the replacement property. This is known as the **buy up/trade up rule**.

If a replacement property is less expensive than the original property, the taxpayer cannot defer taxes on the difference in value. Any money that is not used for reinvesting in a replacement property will be taxed.

Any replacement property or uses of funds that do not meet the qualifications for a tax-deferred exchange are referred to as a **boot**. All boots are subject to full taxation.

For example, say Mr. Schultz previously bought an investment property for $325,000. He later decides to do a 1031 exchange and sells it for $500,000. Mr. Schultz decides to take out $50,000 out of the $175,000 profit for repairs on his personal residence. Mr. Schultz can still qualify for a tax-deferred exchange, but he will only be able to defer taxes on the remaining $125,000 and will be taxed on the $50,000 used for home repairs.

The taxpayer must be the **same entity** for the sale of the original property and the purchase of the replacement property. One exception to the same entity rule is if the taxpayer dies during the course of the exchange. In this case, the taxpayer's spouse or heirs may complete the exchange to receive tax-deferred status.

A taxpayer's intent to use a 1031 exchange must be disclosed within 45 days of the sale of the original property.

Installment Sale

An **installment sale** allows investors to defer taxes on capital gains generated by rental income-producing properties to a future tax year, as opposed to paying them in the standard year. In this case, current taxes will be paid with inflated future dollars.

In an installment sale, a buyer must make regular, agreed-upon installment payments.

A taxpayer must make at least one tax payment in the first taxable year after the profit is generated.

Installment sales provide major advantages to real estate investors who rely on capital to fund new purchases. An installment sale allows investors to:

- Avoid paying higher taxes
- Retain more money for the purpose of reinvesting in the economy
- Reduce their overall tax liability

Installment sales only apply to properties that are sold for a profit. The standard IRS rules for installment sales do not apply if a property is sold at a monetary loss.

Leaseback

A **leaseback** – or sales-leaseback, purchase lease, or sale lease – is a transaction in which an investor sells a property in order to free up capital for another purpose, but continues to lease the property.

A seller leases the property from the buyer via tax-deductible rent payments. Most leasebacks then provide the option of allowing the seller to buy back the property after the duration of the lease.

For example, say a real estate developer needs more capital to complete a 10-unit apartment building. The developer decides to do a leaseback of two units on the property in order to free up funds. The freed capital provides the necessary resources for the developer to finish the development project and after the duration of the leaseback, the developer is able to buy back the property.

This strategy is particularly common for businesses that do not want the liability of a mortgage. It allows a business to save on incurred costs (i.e. property taxes, maintenance) and make reduced rental payments to a buyer.