Chapter 14

Real Property Taxation

Chapter 14 Goals:

- How real estate taxes are assessed and how the state derives at a homeowner's property tax bill
- What are capital gains and how are they taxed
- How capital gains and depreciation affects property taxes
- How the various California propositions affect property taxes
- Important real estate terms used in calculating property taxes
- How exchanges can help alleviate the property tax burden of the buyer or seller
- Recognizing the advantages of owning a single family residence with regard to reduced property taxes
- Understanding the tax implications of selling and differences in property taxes between residents of the United States and foreigners
- What are tax shelters and how do they work

Chapter 14: Real Property Taxation

Key Terms

1031 exchange acquisition indebtedness adjusted basis American Recovery and Reinvestment Act appraisal value method assessed value method basis boot buy up/trade up rule capital gain cost basis deferred exchange deferred gain depreciable basis depreciation equity indebtedness	excluded gain federal withholding tax forced sale Foreign Investment in Real Property Tax Act homeowner's exemption installment sale leaseback like-kind Mortgage Foreclosure Debt Relief Act of 2007 original basis primary residence property tax calendar property taxes Proposition 13 Proposition 58	Proposition 60 Proposition 90 realized gain real property assessment real property tax benefit recognized gain reverse exchange same entity seller's gain Senior Citizen Property Tax Postponement Program special assessment supplemental tax bill tax-deductible expenses universal tax exclusion veteran's exemption

Chapter Overview

After reading this chapter, readers will understand:

- The purpose of property taxes
- How property taxes are calculated and collected
- The various California propositions affecting property taxes
- The tax benefits of homeownership, including exemptions and tax-deductible expenses
- Capital gains and how they are taxed
- Depreciation and how it affects property taxes
- Tax deferrals and how they alleviate the property tax burden on homeowners
- Various tax relief acts
- Federal and state withholding taxes

Property Tax Basics

Property taxes are at the cornerstone of local tax revenue. These taxes contribute to schools, roads, and local infrastructure, as well as the police department, fire department, and other local vital services. These services improve a community and ultimately result in higher property values over time.

Real estate taxes are assessed based on a property's value. The tax rate is a percentage of the assessed value. Property taxes are deductible on a homeowner's tax return.

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

Real estate taxes dramatically affect a prospective buyer's ability to buy a property. In times when property taxes are high or when property values have significantly increased, buyers may be discouraged from purchasing a home. Conversely, buyers may be incentivized to buy in a certain community where taxes are low.

Property tax payments must be kept current or the delinquent party will be subject to fees and increased payments. Unlike income taxes, which can reduced by claiming a lower income, property taxes must be paid in full or a property may go into foreclosure.

A **real property assessment** is a property evaluation to determine the value of a property to use as the basis for property taxes.

Property Tax Calendar

The property tax fiscal year begins on July 1st and ends on June 30th.

Property taxes are broken down into two equal payments to be paid twice a year:

- First Payment Due Date: November 1st
- First Payment Delinquent Date: December 10th
- Second Payment Due Date: February 1st
- Second Payment Delinquent Date: April 10th

Billing

A local county will send a property tax bill to a homeowner prior to the payment's due date.

If a homeowner's property taxes are paid directly through a lender, the tax bill will be sent directly to the lender. It is a homeowner's responsibility to keep a tax bill current, even if a lender is responsible for property tax payments.

A property tax bill includes information about the following:

- Property parcel number

- Tax rates and charges
- Assessed land value
- Assessed property value
- Exemptions

SECURED PROPERTY TAX BILL 2011 - 2012

FOR FISCAL YEAR BEGINNING July 1, 2011 AND ENDING June 30, 2012

City and County of San Francisco – José Cisneros, Treasurer and Tax Collector – WWW.SFGOV.ORG/TAX

INTERNET COPY

VOL	BLOCK NO.	LOT NO.	ACCOUNT NO.	TAX BILL NO.	TAX RATE	PROPERTY LOCATION
			000000000			

Parcel number

INFORMATION

Property Valuation: 415-554-5596 (Assessor-Recorder)
Homeowner's/Other Exemptions: 415-554-5596 (Assessor-Recorder)
Current Year Taxes: 415-554-4400 (Taxpayer Assistance)
Prior Year Delinquencies: 415-554-4499
E-mail: Treasurer.TaxCollector@sfgov.org

Generally deductible

ASSESSMENT INFORMATION

ASSESSMENT	FULL VALUE	TAX RATE	TAX AMOUNT
LAND	$617,233.00	1.1718 %	$7,232.73
IMPR/STRUCTURAL	$411,484.00		$4,821.76
IMPR/FIXTURES	$0.00		$0.00
PERSONAL PROPERTY	$774.00		$9.06
GROSS TAXABLE VALUE	$1,029,491.00		$12,063.57
LESS: EXEMPTIONS			
HOMEOWNER'S	$0.00		$0.00
OTHER	$0.00		$0.00
NET TAXABLE VALUE	$1,029,491.00		$12,063.57

DIRECT CHARGES AND/OR SPECIAL ASSESSMENTS:
(Call For Information)

Generally nondeductible

CODE	TYPE	PHONE NO.	
29	Rent Stabilization Fee	(415) 554-4452	$145.00
89	SFUSD Facilities District	(415) 355-2203	$81.60
92	Apartment House License Fee	(415) 558-6288	$326.00
98	SF – Teacher Support	(415) 355-2203	$208.46
	TOTAL DIRECT CHARGES AND SPECIAL ASSESSMENTS		$761.06

DUE NOVEMBER 1, 2011 FIRST INSTALLMENT: $6,412.31	DUE FEBRUARY 1, 2012 SECOND INSTALLMENT: $6,412.31	TOTAL DUE: $12,824.62

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 "net taxable value" of your property is multiplied by the tax rate. The corresponding "tax amount" is generally deductible.

-The remaining amounts are not computed by multiplying a tax rate. These amounts are generally nondeductible.

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

Real Property Tax Assessment

A **real property tax assessment** refers to when the government evaluates a property to determine its current market value. A property's value is reassessed whenever a property is sold, or when the value of the property increases significantly.

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

If a homeowner believes that the government's assessment is incorrect, he or she may hire a certified appraiser to evaluate the property. An appraiser's valuation can be used to prove that property taxes are too high.

If a homeowner cannot afford an appraisal, he or she can create a list of recently sold properties, calculate the average price per square foot, and verify that the figures are accurate with the county tax office. If the county tax office used an inflated average price per square foot for its real property tax assessment, the homeowner may be able to get his or her tax bill reduced.

Supplemental Tax Bill

After a buyer purchases a property and its value it reassessed, he or she will receive a supplemental tax bill. A **supplemental tax bill** is the difference between the old tax bill and the reassessed property value.

The new homeowner will likely receive two or three property tax bills during his or her first year of homeownership. The first tax bill is the old property tax bill; the second, and possibly third, tax bill is the supplemental tax bill.

Special Assessment

A **special assessment** is a tax increase that provides the local government with additional funding to improve community-based conditions, such as roads, lighting, sewage, or irrigation.

The local government has the ability to impose a special assessment provision on neighborhood property owners at its discretion. However, the city or county must approve it by a two-thirds margin.

Proposition 13

Proposition 13 was passed in 1978 to reduce property taxes.

Prior to Proposition 13, local counties established their tax rates independently and the total property tax rate was a composite of individual rates.

Under Proposition 13, the maximum tax rate for property taxes is 1% (in addition to any approved special assessment taxes) and annual property tax increases are capped at 2% per year.

Furthermore, Proposition 13 dictated that the transfer of a property title to a family member did not constitute a reassessment of the property tax bill. This new provision drastically improved a family's ability to refinance a home using the credit of another titleholder.

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

Proposition 58

Proposition 58 expanded the provisions set forth in Proposition 13.

Proposition 58 states that a property's value will not be reassessed if the title is transferred to an heir of the deceased homeowner. This means that a deceased homeowner's children or grandchildren will be pay the same property taxes that were paid by their parents or grandparents.

This provision significantly reduces the likelihood that an heir's property will be foreclosed on due to increased property taxes.

In this case, an heir must be the original homeowner's natural born child, stepchild, son-in-law or daughter-in-law, or a child that was adopted prior to the age of 18.

The original homeowner must file an application with the county indicating that the property will be transferred to a child or grandchild. It must indicate the purpose of the transfer and whether the heir will use the property as a principal residence.

Proposition 60

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

The qualifications for Proposition 60 include:

- The homeowner must be at least 55 years old or have a verifiable disability. If there are multiple homeowners, only one must be over the age of 55.
- The home must be the homeowner's principal residence.

- The new property must be within the same county as the original property
- The new property must be equal to or less than the current value of the homeowner's original home.
- The original property must be eligible for an exemption prior to the purchase of the new property.

A senior citizen can transfer a property tax bill once. However, in the event that a senior citizen becomes disabled after an initial downsize and wishes to downsize further, the county will transfer the property tax bill a second time.

Proposition 90

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.

Each county has its own unique property tax laws and not every county accepts Proposition 90. Proposition 90 is accepted in the following California counties: Alameda, Kern, Modoc, Monterey, Santa Clara, San Diego, San Mateo, and Ventura.

Tax Benefits of Homeownership

Owning a home produces significant tax breaks in the form of **real property tax benefits**. This is when a property owner reduces their overall tax liability because of their home ownership. In order to qualify for homeowner tax breaks, a taxpayer must file a 1040-A tax return and indicate tax-deductible expenses. (EZ tax returns do not qualify.)

Primary Residence

Unlike an investment property, which is used to make money, a **primary residence** is used for the purpose of living.

The following property types fall under the primary residence category:

- Single-family home
- Condominium
- Mobile home
- House boat
- Trailer

- Shared housing

If a property is a multi-unit, the unit the owner lives in is considered a principal residence.

Primary residences are given special tax breaks by the government for the purpose of promoting homeownership and keeping homeowners in their homes.

If a taxpayer owns multiple residences, only one can be considered a primary residence. Any property that is not a primary residence is referred to as a secondary residence. Secondary residences are taxed less favorably than primary residences, as they do not qualify for tax exclusions or write-offs.

Universal Tax Exclusion

Universal tax exclusion can be used to the benefit of most homeowners once every two years. It allows an individual homeowner to qualify for tax exclusion on gains of up to $250,000; joint tax filers can exclude up to $500,000.

A homeowner/taxpayer must meet the following guidelines:

- The subject property is the taxpayer's primary residence and has been for at least two of the previous five years prior to a sale (the years do not have to be consecutive)
- The property was not acquired using a tax-deferred exchange during the previous five years
- The taxpayer did not claim tax exclusion in the two years prior

Example

Say Mary and Bob purchased a principal residence in 2007 for $395,000. Seven years later, Mary and Bob decide to sell the home and upgrade to a larger one. They sell the home for $545,000. As Mary and Bob meet all the qualifications for universal tax exclusion, the $150,000 in profit will not be taxed.

Forced Sale

A **forced sale** refers to when a homeowner is forced to relocate because of circumstances relating to health, employment, or an emergency. In this case, partial tax exclusion may be provided even if a homeowner has not lived in his or her home for the required two out of the five years.

The partial tax exclusion is found through the following formula:

Time in a home (in months) /
<u>24 months (standard exclusion requirement)</u>
Partial Tax Exclusion

Percentage Tax Exclusion

For example, Jon and Pam have only lived in their Houston house for twelve months when Jon's company relocates to New York. Although they did not live in their home for the required two years, Jon and Pam can still qualify for partial tax exclusion for the profit on the sale of their home.

The number of months they spent in their home divided by the exclusion requirement is reflected by: (12/24=0.50). If Jon and Pam's Houston home sells for a profit of $170,000, they can multiply the percentage tax exclusion by the gain from the sale (170,000 x 0.50) and exclude $85,000 from being taxed.

Basis

Basis refers to the total cost of repairing, building, and/or improving a property. Only expenses that are paid out are included, such as the cost of labor, materials, permits, and city, legal, and engineer fees.

Should a taxpayer work on the property him- or herself, the cost of labor is not considered.

Example

The Smith family bought vacant land for $220,000 for the purpose of developing it as their primary residence. The cost of material and labor is $250,000. Permit and city fees are $7,000. Therefore, the total basis of for the new property is $477,000.

Acquisition Indebtedness

Acquisition indebtedness refers to the total debt a taxpayer faces as a result of purchasing and renovating a qualified property.

Acquisition indebtedness can be written off for a maximum of $1,000,000.

The IRS defines acquisition indebtedness as:

a. *"The principal indebtedness incurred in acquiring or improving the property*

b. *The principal indebtedness incurred before the acquisition or improvement of the property if such indebtedness would not have been occurred by for such acquisition or improvement, and*

c. *The principal indebtedness incurred after the acquisition or improvement if such indebtedness would not have been incurred but for such acquisition or improvement and such indebtedness was reasonably foreseeable when the property was acquired or improved."*

Equity Indebtedness

Equity indebtedness refers to any indebtedness that is not considered acquisition indebtedness. This includes the cost of debt not used for the purchase, repair, or construction of a property.

Equity indebtedness cannot exceed $100,000, assuming the value of the debt does not exceed the property value.

Tax-Deductible Expenses

A taxpayer can 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 save depends on his or her filing status, taxable income amount, itemized deductions, and the deduction amount.

All expenses must be documented. Without proof, writing off expenses can be difficult to prove.

Recurring costs (i.e. property insurance, homeowner's association fees) are not tax-deductible. Any home improvements or maintenance that are not medical care-related cannot be written off.

Nonrecurring costs (i.e. credit reports, inspections, recording fees) are tax-deductible. Other tax-deductible expenses include:

- *Mortgage interest.* A homeowner with a loan below $1 million can deduct mortgage interest on his or her taxes. A homeowner with a loan of above $1 million can still qualify for tax benefits, although the IRS will limit the total deductibles. Only a homeowner's first two properties can qualify for mortgage interest tax deductions, one of which must be the homeowner's primary residence. Additional homes are subject to the full taxation.

- *Mortgage points.* Tax-deductible if the deductions occur in the same year as the purchase or in the year in which the points were paid. Points may also be spread out over the life of the loan. Taxpayers should consult with an accountant over the specific rules and maximum deduction amounts they can qualify for every year.

- *Property taxes.* A buyer should indicate the total amount that was reimbursed to the seller. Property taxes will be listed on the settlement sheet.

- *Home equity line of credit.* The interest is tax-deductible if deducted in the same year the property is purchased.

- *Mortgage insurance premiums*

- *Medical care home improvements.* Any medical care-related improvements made to a property are tax-deductible. For example, adding railways or special ramps.

Exemptions

There are partial or full tax exemptions for certain types of homeowners, including veterans and seniors.

Homeowner's Exemption

A **homeowner's exemption** awards a tax break of up to $7,000 on the cash value of a homeowner's property.

Only the owner or co-owner of a property who resides in it as a primary residence can apply for an exemption. To owner/co-owner must occupy the residence within 90 day after a homeownership change or within 90 days of construction being completed.

A homeowner cannot qualify if he or she has already received an exemption that is greater than a homeowner's exemption. If an applicant has received a lesser exemption, the difference between the lesser exemption and the homeowner's exemption will be awarded.

Veteran's Exemption

Veterans can qualify for a **veteran's exemption** of up to $4,000 on the cash value of a property.

California also allows a veteran or the spouse of a deceased veteran to receive a \$100,000 exemption. Low-income disabled veterans can qualify for up to a \$150,000 exemption. Veterans may only qualify for one exemption.

A veteran's exemption only applies to a veteran's primary residence. Veterans may only qualify for one exemption.

The exemption levels are adjusted for inflation based on the consumer price index (CPI).

Investment Properties

Investment properties are taxed differently than primary residence properties.

Depreciation

In the context of real estate, **depreciation** refers to the reduction in value, or capital loss, on a property. Depreciation is calculated through a blend of factors, including a property's purchase price, closing costs, land value, home improvements, and property type.

In order to calculate a property's depreciation, one must do the following:

1. Find original basis
2. Determine land value
3. Calculate depreciable basis
4. Find adjustable basis
5. Determine the property type (residential vs. commercial)
6. Determine which recovery period will be used
7. Find the corresponding month and the rate of the month
8. Calculate the depreciation (using the depreciation formula below)

Depreciation Formula

Property Value - Land Value ÷ 27.5 (IRS useful life equation) = Depreciation

Depreciation Chart

Mo/Yr	1	2-9	10-26 Even Years	11-27 Odd Years	28	29
Jan	3.458	3.636	3.637	3.636	1.970	0.000
Feb	3.182	3.636	3.637	3.636	2.273	0.000
Mar	2.879	3.636	3.637	3.636	2.576	0.000
Apr	2.576	3.636	3.637	3.636	2.879	0.000
May	2.273	3.636	3.637	3.636	3.182	0.000
Jun	1.970	3.636	3.637	3.636	3.485	0.000
Jul	1.667	3.636	3.636	3.637	3.636	0.152
Aug	1.364	3.636	3.636	3.637	3.636	0.455
Sep	1.061	3.636	3.636	3.637	3.636	0.758
Oct	0.758	3.636	3.636	3.637	3.636	1.061
Nov	0.455	3.636	3.636	3.637	3.636	1.364
Dec	0.152	3.636	3.636	3.637	3.636	1.667

Property Tax Depreciation

Optional MACRS GDS Percentage Tables

a. MACRS 5-Year Property (200% DB)

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	20.00%	35.00%	25.00%	15.00%	5.00%
2	32.00	26.00	30.00	34.00	38.00
3	19.20	15.60	18.00	20.40	22.80
4	11.52	11.01	11.37	12.24	13.68
5	11.52	11.01	11.37	11.30	10.94
6	5.76	1.38	4.26	7.06	9.58

b. MACRS 7-Year Property (200% DB)

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	14.29%	25.00%	17.85%	10.71%	3.57%
2	24.49	21.43	23.47	25.51	27.55
3	17.49	15.31	16.76	18.22	19.68
4	12.49	10.93	11.97	13.02	14.06
5	8.93	8.75	8.87	9.30	10.04
6	8.92	8.74	8.87	8.85	8.73
7	8.93	8.75	8.87	8.86	8.73

c. MACRS 15-Year Property (150% DB)

	Half-year convention	Mid-quarter convention			
Year		First quarter	Second quarter	Third quarter	Fourth quarter
1	5.00%	8.75%	6.25%	3.75%	1.25%
2	9.50	9.13	9.38	9.63	9.88
3	8.55	8.21	8.44	8.66	8.89
4	7.70	7.39	7.59	7.80	8.00
5	6.93	6.65	6.83	7.02	7.20
6	6.23	5.99	6.15	6.31	6.48
7	5.90	5.90	5.91	5.90	5.90
8	5.90	5.91	5.90	5.90	5.90

d. Residential Rental Property-GDS (27.5-year S/L with mid-month convention)

	Use the row for the month of the taxable year placed in service.					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Jan.	3.485%	3.636%	3.636%	3.636%	3.636%	3.636%
Feb.	3.182	3.636	3.636	3.636	3.636	3.636
March	2.879	3.636	3.636	3.636	3.636	3.636
Apr.	2.576	3.636	3.636	3.636	3.636	3.636
May	2.273	3.636	3.636	3.636	3.636	3.636
June	1.970	3.636	3.636	3.636	3.636	3.636
July	1.667	3.636	3.636	3.636	3.636	3.636
Aug.	1.364	3.636	3.636	3.636	3.636	3.636
Sept.	1.061	3.636	3.636	3.636	3.636	3.636
Oct.	0.758	3.636	3.636	3.636	3.636	3.636
Nov.	0.455	3.636	3.636	3.636	3.636	3.636
Dec.	0.152	3.636	3.636	3.636	3.636	3.636

Cost Basis

Cost basis is used instead of a property's purchase price to determine the accurate capital gains or losses resulting from the purchase or sale of a property.

It refers to a property owner's capital investment, including depreciation, losses, profits, and amortization. Cost basis also includes all other expenses related to ownership, such as interest, property taxes, closing costs, and improvements.

An escrow statement includes an itemized breakdown of all expenses. These expenses can be broken into four groups:

- *Purchase price (PP).*
- *Operating expenses (OE).* Refers to the recurring costs that an owner must pay every month to manage a property, such as mortgage interest, insurance, and taxes.
- *Buying expenses (BE).* Refers to all nonrecurring, one-time closing costs, such as agent/broker commissions and escrow and title fees.
- *Nondeductible items (ND)*

Financing does not affect the cost basis.

Original Basis

The **original basis** refers to a property's purchase price (PP) plus buying expenses (BE).

Property's Purchase Price (PP) +
<u>Buying Expenses (BE)</u>
Original Basis

Depreciable Basis

The **depreciable basis** is used to calculate the amount of depreciation that has occurred. The following formula determines depreciable basis:

Original Basis –
<u>Land Value</u>
Depreciable Basis

Land value can be determined through one of two common methods:

- ***Assessed Value Method.*** Uses comparable home sales to find the average price per square foot, which is multiplied by the total square feet of a subject property.

- ***Appraisal Value Method.*** A certified appraiser conducts an appraisal of a subject property. This method is not encouraged as appraised values may reflect a higher value than the assessed value method.

Adjusted Basis

Adjusted basis calculates the capital gains and losses when a property is sold. The formula to determine adjusted basis is a property's original basis, plus the cost of improvements (repair or replacement), minus the cost of depreciation.

Original Basis +
Cost of Improvements –
Depreciation
Adjusted Basis

For an item to be depreciated, a homeowner must make improvements to the property. The purpose of depreciation is to encourage more investment by leaving more money in the hands of investors to circulate throughout the economy.

If an item or section of a property needs to be repaired or replaced, the expense is subtracted from a homeowner's income.

Home Improvements

A homeowner should keep track of all expenses related to home improvement as a way of reducing his or her recognized gain and lowering his or her tax obligations.

This involves saving receipts, contractor contracts, and copies of checks that prove the cost of expenses.

To reduce tax liability, home improvements are added to the basis. Increasing the basis ultimately reduces the gain in a transaction.

The IRS defines home improvements as replacement items of great value. The following improvements qualify for tax deductions:

- Roof
- Walls
- Electrical system
- Heating/Cooling system
- Pipes
- Drainage
- Walls

- Flooring
- Leveling
- Water system
- Solar
- Pools
- Fencing

The IRS does not include maintenance items. The following improvements do not qualify for tax deductions:

- Furniture
- Lamps
- Lighting
- Drapes
- Painting
- Carpeting
- Appliances

Depreciation

In order to find the cost of depreciation, one must evaluate the type of property, the recovery period, and the month in which the recovery period begins. The recovery period is the period used to calculate real estate depreciation using the real estate depreciation formula found on page 13 of this chapter. The recovery period for residential real estate is 27.5 years and 39 years for nonresidential real estate.

There are two types of property:

- *Residential* (i.e. single-family residence, duplex, triplex, fourplex, apartment building)
- *Nonresidential* (i.e. places of business, trade, education, defense, industrial, or commercial)

Both residential and nonresidential real estate use the straight-line depreciation method to measure depreciating value based on lifespan. Residential rental depreciation is 27.5 years; nonresidential real estate depreciation is 39 years.

Although the depreciation calculation seems difficult, it is much easier to understand when using real world scenarios.

Example

The Eldridge family recently purchased a fourplex on August 10th. The purchase price was $400,000. The closing costs were $10,000. The land of the property is valued at $150,000.

In order to calculate the year's depreciation, Mr. and Mrs. Eldridge use the following formula:

1. Purchase Price + Buying Expenses (Closing Costs) = Original Basis
   $400,000 + $10,000 = **$410,000**
2. Original Basis – Land Value = Depreciable Basis
   $410,000 – $150,000 = **$260,000**
3. Property Type
   Four-plexes are residential and therefore, they use the **27.5-year** recovery period to calculate depreciation.
4. Month property was bought: August
   August corresponds to month 8. This produces a percentage of 1.364, which is expressed as 0.01364 when calculating depreciation
5. Multiply the depreciable basis by the level of depreciation.
   $260,000 (0.01364) = $3,546.04

Tax-Deferral and Postponement

1031 Exchanges

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. Many property owners become reluctant to sell their properties, which inhibits economic activity.

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

A **1031 exchange** is a federal tax provision that allows sellers 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.

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.

Example of a 1031 Exchange

Mr. Johnson currently owns a 5-unit apartment. He wants to invest his earnings in another property to defer paying capital gains taxes. If he sells the property for $500,000 and has closing costs of $15,000 with an adjusted basis of $125,000, his taxable gain would be:

Sales Price	$500,000
Closing Costs	- 15,000
Net Sales Price	$475,000
Adjusted Basis	- 125,000
Capital Gain	$300,000

If Mr. Johnson buys another investment property within 180 days, he can defer paying capital gains taxes on the $300,000 profit from the sale.

Once a taxpayer submits a property for a 1031 exchange, he or she is not allowed to leave the exchange. The taxpayer must defer taxes and cannot indicate a profit or loss on the transaction.

The three main types of 1031 exchanges are:

- Simultaneous exchange
- Deferred exchange
- Reverse exchange

Simultaneous Exchange

In a simultaneous exchange, the proceeds from the sale of the original property will immediately be used to purchase the replacement property. In this scenario, the taxpayer typically has two properties in escrow: one for sale and one for purchase.

Deferred Exchange

In a **deferred exchange**, a seller can save the proceeds from the sale of the original property until a replacement property is found.

The taxpayer has 45 days after the sale of the original property to identify a replacement property and must purchase one within 180 days. Extensions will only be provided if there is a federally declared disaster.

Under all the various exchange methods, a taxpayer is required to keep the tax-deferred proceeds with a third party intermediary or escrow company until the taxpayer purchases the replacement property. Any profit accessed by the taxpayer prior to the purchase of a replacement property is subject to full taxation.

Reverse Exchange

Under a 1031 exchange, a taxpayer cannot own the original and the replacement properties at the same time.

A **reverse exchange** allows an accommodation titleholder to hold the replacement property on a taxpayer's behalf for a maximum of 180 days. This gives the taxpayer ample time to sell his or her original property without losing out on buying the replacement property.

Boot

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

A boot occurs when:

- A taxpayer uses the proceeds from the sale of the original property for a purpose other than purchasing a replacement investment property.
- A taxpayer's replacement property is cheaper than the original property. (In this case, the difference in pricing is the boot.)
- Excess cash is held by the third party intermediary

All boots are subject to full taxation.

"Boot" is not an official IRS term; however, it is commonly used when talking about the tax implications of a 1031 exchange.

Installment Sale

The amount of taxes owed by a property owner per year is based on the amount of income received.

An **installment sale** allows taxpayers to spread taxes on profits generated by income properties over two or more taxable years, as opposed to paying them all in the same year. In this case, future taxes are paid with inflated dollars.

Installment sales provide major advantages to real estate investors who rely on capital to fund new purchases. An installment sale allows investors to retain more money for the purpose of reinvesting in the economy.

The main requirement for an installment sale is that the taxpayer pay at least one tax installment in the first taxable year after the profit.

Leaseback

A **leaseback** – or sales-leaseback, purchase lease, or sale lease – is a transaction in which a seller sells a property to a buyer in order to free up capital for a particular purpose. The 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.

Leasebacks are common in commercial real estate. Oftentimes, a corporation will sell a property to an investor, who then leases the property back to the corporation. This provides a corporation with the following advantages:

- Frees up capital for the corporation to invest in buying more equipment, hiring more employees, or growing other businesses
- Reduces corporation's liabilities and debts
- Reduce corporation's tax liabilities

The terms of the lease are dependent on the new owner's financing costs, the lessee's credit rating, and the condition of the real estate market.

In the aftermath of the 2008 real estate collapse, it became more difficult for developers to obtain loans. The leaseback was a creative solution that provided investors with the capital required to finish their development projects.

Senior Citizen Property Tax Postponement Program

The **Senior Citizen Property Tax Postponement Program** was created to reduce the property tax burden faced by senior citizens and to reduce the threat of foreclosure. It postponed property taxes until a senior citizen's property was sold or until the individual no longer occupied the home.

The main qualification for the program was that the homeowner be at least 62 years old. Any blind or fully disabled individual could also apply.

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

Capital Gains

Capital gains are defined as income derived from the sale of capital (i.e. property).

Prior to 1997, real estate capital gains were taxed at a rate of 28%. The Taxpayer Relief Act of 1997 dramatically reduced the rate to 20%. In 2003, capital gains taxes were reduced further from to 15%.

Capital gain taxes were also reduced from 10-15% to 5% for lower-income property owners. In 2008, these taxes were eliminated altogether.

This reduced rate applies to homeowners who hold onto a property for more than 12 months.

These radical changes on capital gains taxes were implemented to encourage homeowners who made a profit from the sale of a property to reinvest those earnings back into the economy.

Types of Gains

A **realized gain,** also known as a **seller's gain,** refers to the total amount a seller nets in the sale of a property.

A taxpayer may use some or all of the gain types when filing out his or her tax return. However, the IRS only taxes property owners for the recognized gain amount. A recognized gain is calculated using a taxpayer's recognized gain, deferred gain, and/or excluded gain.

- **Recognized gain.** The taxable portion of a realized gain. A recognized gain can be deferred.
- **Deferred gain.** The taxable portion of a realized gain that is deferred. A deferral can be the result of a 1031 exchange or a pre-1997 law stating that sellers who claimed a capital gain could defer taxes through a term called rollover.
- **Excluded gain.** The portion of a realized gain on which a taxpayer is excluded from paying taxes. This typically relates to the sale of a taxpayer's primary residence in which the taxpayer can exclude up to $250,000 for an individual or $500,000 for married joint filers.

Calculating Seller's Gain

In order to calculate a seller's gain, the following items are required:

- Escrow statement
- Seller's expenses
- Property's purchase price
- Adjusted basis

The formula used to calculate a seller's gain is:

Sales price –
Seller's expenses –
<u>Adjusted basis</u>
Seller's Gain

A seller's expenses in a transaction are not tax-deductible. However, if a seller helps cover a buyer's expenses, they can be used to reduce the seller's gain.

Example

Mr. Johnson sells his house for $2,000,000. His escrow statement includes the following expenses:

For the purpose of this example the costs would be:

Title insurance fee:	$600
Agent commission:	$20,000
Recording fees:	$80
Notary fees:	$70
Title charges:	$60
Escrow fees:	$250
Credit report:	$25
Termite report:	$45
Deed preparation:	$25
Total Selling Expenses:	**$21,155**

Purchase Price: $2,000,000
Selling Expenses: $21,155
Adjusted Basis: $550,000 (depreciation of property)

$2,000,000 (sales price) – $21,155 (selling costs) = Sales Price
– $550,000 (adjusted basis)
= $289,000 Total Gain

Tax Acts

Mortgage Foreclosure Debt Relief Act of 2007

Prior to 2007, any forgiven debt was subject to taxation, including real estate debt.

This changed with the explosion of foreclosures beginning in late 2007 and early 2008. In response to the real estate crisis, the government passed the **Mortgage Foreclosure Debt Relief Act of 2007**. Aimed at alleviating the burden on borrowers whose properties were being foreclosed upon, the Act stipulates that property owners could not be taxed on forgiven real estate debt.

American Recovery and Reinvestment Act

Following the 2008 real estate market collapse, the federal government created and passed the **American Recovery and Reinvestment Act**. The program provided first-time homebuyers with a tax credit of up to $8,000.

The program ended on December 1, 2009.

Foreign Investment in Real Property Tax Act (FIRPTA)

Prior to 1980, foreigners who sold property in the United States could avoid paying taxes on capital gains resulting from the sale of property. This was because the IRS has a difficult time collecting income taxes from foreigners.

The government passed the **Foreign Investment in Real Property Tax Act** to combat this problem.

Now, a buyer who purchases a property from a foreigner must withhold 10% of the purchase price for tax purposes. This is known as a **federal withholding tax**.

A buyer must disclose and pay this federal withholding tax to the IRS within 10 days of the property being sold. Should a buyer fail to pay the tax in the 10-day period, the buyer may be subject to the foreigner's tax liabilities or to penalties of up to 10% of the property's purchase price.

Federal withholding taxes only apply to primary residences sold at over $300,000 and other properties (i.e. investment, rental, commercial). The purchase of a primary residence below $300,000 from a foreigner is not subject to federal withholding taxes.

If a combination of foreign and American individuals owns a property, withholding taxes will be prorated based on the ownership stake in the property. Ownership stake is based on the percentage of capital investment.

For example, if two people own a property, each with a 50/50 capital investment in the property, withholding taxes will be prorated at a rate of 50/50.

A buyer has a responsibility to verify whether a seller is foreign or not. An agent should always request that escrow/title look into a seller's background. Escrow may ask a seller to provide his or her U.S. taxpayer identification number or an affidavit of non-foreign status.

CERTIFICATE OF NON FOREIGN STATUS

Section 1445 of the Internal Revenue Code provides that a transferee (buyer) of a U.S. real property interest must withhold tax if the transferor (seller) is a foreign person. To inform ____ (the "Transferee") that withholding of tax is not required upon the disposition of a U.S. real property interest by ____ (the "Transferor"), the undersigned hereby certifies the following on behalf of the Transferor:

1. That the Transferor is the owner of the following described property, to wit:

Block: ________________ Lot: ________ County: ____________________

Premises: ____

2. The Transferor is not a non-resident alien for purposes of the U.S. income taxation (as such term is defined in the Internal Revenue Code and Income Tax Regulations).

3. The Transferor's U.S. taxpayer identification number (Social Security Number) is ____________________

4. The Transferor's address is ____
____

5. The Transferor understands that this certification be disclosed to the Internal Revenue Service by the Transferee and that any false statement contained herein could be punished by fine, imprisonment or both.

UNDER PENALTIES OF PERJURY, I DECLARE THAT I HAVE EXAMINED THIS CERTIFICATION AND TO THE BEST OF MY KNOWLEDGE AND BELIEF IT IS TRUE, CORRECT AND COMPLETE, AND I FURTHER DECLARE THAT I HAVE AUTHORITY TO SIGN THIS DOCUMENT ON BEHALF OF THE TRANSFEROR.

DATED: ____________________________

BY:________________________________

BY:________________________________

BY:________________________________

BY:________________________________

Failure to verify a seller's status may result in a situation where a buyer fails to pay withholding taxes and is subject to significant penalties.

California has adopted a similar statewide measure.

In California, buyers who purchase properties from a foreigner must pay an additional withholding tax equal to 3.3% of the purchase price.

Therefore, the total cost of withholding taxes in California is 13.3%: 10% for federal and 3.3% for California.

A buyer of any property other than a primary residence must also pay a 3.5% withholding tax. A buyer is excluded from paying withholding tax when a property sells:

- For below $100,000
- At a loss (includes closing costs, construction costs, etc.)
- Using a tax-deferred exchange

TAXABLE YEAR **2017**

Real Estate Withholding — Computation of Estimated Gain or Loss

CALIFORNIA FORM **593-E**

(You are required to complete this form if you claim an exemption due to a loss or zero gain or if you elect an optional gain on sale withholding amount.)

Part I – Seller/Transferor Information

Name	SSN or ITIN
Spouse's/RDP's name (if jointly owned)	Spouse's/RDP's SSN or ITIN (if jointly owned)
Address (apt./ste., room, PO box, or PMB no.)	☐ FEIN ☐ CA Corp no. ☐ CA SOS file no.
City (If you have a foreign address, see instructions.)	State / ZIP code
Property address (if no street address, provide parcel number and county)	

Part II – Computation

1 **Selling price** . . . . . . 1 ______

2 Selling expenses . . . . . . 2 ______

3 **Amount realized.** Subtract line 2 from line 1 . . . . . . 3 ______

4 Enter the price you paid to purchase the property (If you acquired the property other than by purchase, see instructions, How to Figure Your Basis.) . . . . . . 4 ______

5 Seller/Transferor-paid points . . . . . . 5 ______

6 Depreciation . . . . . . 6 ______

7 Other decreases to basis . . . . . . 7 ______

8 Total decreases to basis. Add line 5 through line 7 . . . . . . 8 ______

9 Subtract line 8 from line 4 . . . . . . 9 ______

10 Cost of additions and improvements . . . . . . 10 ______

11 Other increases to basis . . . . . . 11 ______

12 Total increases to basis. Add line 10 and line 11 . . . . . . 12 ______

13 **Adjusted basis.** Add line 9 and line 12 . . . . . . 13 ______

14 Enter any suspended passive activity losses from this property . . . . . . 14 ______

15 Add line 13 and line 14 . . . . . . 15 ______

16 **Estimated gain or loss on sale.** Subtract line 15 from line 3 and enter the amount here. If you have a loss or zero gain, skip lines 17 and 18. Complete the Seller/Transferor Signature area below and check the box on Form 593-C, Real Estate Withholding Certificate, Part II line 3. If you have a gain, go to line 17 . . . . . . 16 ______

17 **Optional gain on sale withholding amount.** Check the applicable box for the filing type.

☐ Individual 12.3% ☐ Corporation 8.84% ☐ Bank and Financial Corporation 10.84%

☐ Non-California Partnership 12.3% ☐ S Corporation 13.8% ☐ Financial S Corporation 15.8%

Multiply the amount on line 16 by the tax rate for the filing type selected above and enter the result on line 17. This is the optional gain on sale withholding amount. If you elect the optional gain on sale withholding amount on line 17, get Form 593, Real Estate Withholding Tax Statement, and check the appropriate box on line 4 (Boxes B-G) for the Optional Gain on Sale Election, and transfer the amount on line 17 to Form 593, line 5. Sign Form 593 to certify the election . . . . . . 17 ______

18 **Total sales price withholding amount.** Multiply the selling price on line 1 by $3^1/_3$% (.0333) and enter the amount on line 18. This is the total sales price withholding amount. If you select the **total sales price withholding amount** on line 18, check Box A "**$3^1/_3$% (.0333) x Total Sales Price**" on line 4 of Form 593, and transfer the amount on line 18 to Form 593, line 5 . . . . . . 18 ______

Seller/Transferor Signature

Title and escrow persons and exchange accommodators are not authorized to provide legal or accounting advice for purposes of determining withholding amounts. Transferors are strongly encouraged to consult with a competent tax professional for this purpose.

To learn about your privacy rights, how we may use your information, and the consequences for not providing the requested information, go to **ftb.ca.gov** and search for **privacy notice**. To request this notice by mail, call 800.852.5711.

Under penalties of perjury, I declare that I have examined the information on this form, including accompanying schedules and statements, and to the best of my knowledge and belief, it is true, correct, and complete. I further declare under penalties of perjury that if the facts upon which this form are based change, I will promptly notify the Real Estate Escrow Person (REEP).

Seller's/Transferor's Name ______ Seller's/Transferor's Signature ______ Date ______

It is unlawful to forge a spouse's/RDP's signature. Spouse's/RDP's Name (if jointly owned) ______

Spouse's/RDP's Signature (if jointly owned) ______ Date ______

Buyer's Affidavit For FIRPTA Withholding Exemption

FLORIDA ASSOCIATION OF REALTORS®

1. I am the transferee (Buyer) of real property located at____

   ____.

2. The sales price (amount realized by Seller on the sale) does not exceed $300,000.

3. I am purchasing the real property to use as a residence. I have definite plans that a member of my family, to include brother(s), sister(s), ancestor(s), descendent(s), or spouse, or I will reside in the property for at least 50% of the number of days that the property is used by any person during each of the first two 12 month periods following the date the property is transferred to me.

4. I am making this affidavit in order to establish an exemption from withholding a portion of the sales price of the property under Internal Revenue Code §1445.

5. I understand that if the information in this affidavit is incorrect, I may be liable to the Internal Revenue Service for up to 10% of the sales price of the property, plus interest and penalties.

Under penalties of perjury, I declare that the statements above are true, correct, and complete.

Buyer Signature	Date
Printed Name of Buyer	Tax Identification Number
Buyer Signature	Date
Printed Name of Buyer	Tax Identification Number

NOTICE: THIS FORM IS INTENDED FOR USE ONLY BY INDIVIDUAL BUYERS (NOT BY CORPORATIONS, PARTNERSHIPS, OR OTHER ENTITIES). THIS FORM DOES NOT NEED TO BE SUBMITTED TO THE INTERNAL REVENUE SERVICE, BUT SHOULD BE RETAINED BY THE PARTIES FOR THEIR RECORDS.