

Understanding Capital Gains

For many real estate investors, the capital gains tax is the single greatest tax obligation on their personal tax returns. Individuals invest in real estate to make money, and many rely on the historical capital appreciation as the sole reason they invested in real estate to begin with. Therefore, limiting capital gains is a major priority when it comes to tax planning for real estate investors. This chapter discusses the major issues concerning capital assets and the tax treatment of any sales.

What Is a Capital Asset?

Gains and losses on the sale of assets must be categorized as either capital or ordinary gain or loss. The gain (or loss) on the sale of a capital asset results in special and sometimes favorable tax treatment. *Capital assets* are generally assets or property used for investment purposes or other property not specifically excepted from capital asset treatment. *Investment property* is property held for the production of income or anticipated appreciation in value, other than property used in your trade or business. Thus, rental property and any type of real estate that is held for investment purposes will be subject to capital treatment upon its sale or disposition. Dealer property, discussed in Chapter 5, is not investment property and does not receive capital treatment upon its sale or disposition.

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For purposes of our discussion, a capital asset is *not*:

- Inventory or stock in trade.
- Property held by the taxpayer for sale to customers in the ordinary course of the taxpayer's business (i.e., "dealer property").
- Depreciable property used in a trade or business.
- Real property used in a trade or business.
- Copyrights and certain property created by the taxpayer's own efforts.
- Accounts receivable or notes receivable.¹

Instead, a capital asset *is*:

- Property held for personal use, such as your home, auto, or furniture.
- Property held for investment or production of income, such as a rental property, a piece of raw land, or general real estate not held in the ordinary course of your trade or business.²

The tax rates are much more favorable on the sale of profitable capital assets as opposed to other types of assets. On the other hand, losses on the sale of capital assets receive unfavorable tax treatment because the deduction on these capital losses is limited per year. At the current time, capital losses can only be deducted up to the total capital gains reported for any particular tax year, and any excess losses are limited to \$3,000 per year or the actual capital loss, whichever is less. Married taxpayers filing separate income tax returns are limited to a maximum capital loss deduction of \$1,500 per year on each separate tax return. Any excess capital loss not fully utilized in the year of sale can be carried forward indefinitely and can be used in the future to offset other capital gains or to utilize the \$3,000 capital loss deduction per year.³

Example

Sara sells real estate and stocks during 2009. She has long-term capital gains and losses for the year. After she adds up her basis in each, she realizes that she made \$50,000 in profit from her real estate ventures, whereas her stock sales lost \$75,000. Here is what her Schedule D (tax form to report gain or loss on sale of capital assets) looks like in numerical terms:

Stock losses:	\$75,000
Real estate gains:	\$50,000
Total net losses:	\$25,000
Loss to deduct in 2009:	\$ 3,000
Amount carried over to 2010:	\$22,000

In 2010, Sara sold real estate again for a \$50,000 net profit and had no stock sales. Here is what her 2010 Schedule D looks like in numerical terms:

Real estate gains:	\$50,000
Loss carried forward from 2009:	\$22,000
Taxable gains in 2010:	\$28,000

Tax Tip

If you are carrying forward large capital losses that will take you several years to recover due to the \$3,000 capital loss limitation per year, you might want to consider selling your investment property (or invest in an investment property) to utilize these losses. For example, you can sell a piece of rental property you own or purchase a piece of real estate for resale. Any capital gains you earn on the sale will be tax free up to the amount of the capital losses you are carrying forward. Also, you might want to consider selling your highly appreciated personal residence or vacation home where the Section 121 exclusion is not available or when your overall gains exceed the \$250,000 or \$500,000 maximum exclusion on the sale of your personal residence (as discussed in Chapter 2).

Capital Gains Tax Rates

If you sell a capital asset that you held for more than 12 months, the holding period is considered long term, and you will receive favorable tax treatment on the sale. Long-term capital gains tax rates were recently reduced by the 2003 Tax Act, implemented on May 5, 2003. The current rates are as follows and depend on your current income tax bracket.

If you're in the 10 or 15 percent income tax bracket (this would apply to married taxpayers filing jointly with a taxable income of less than \$65,100 for 2008 and single taxpayers earning up to \$32,550 in 2008):

- For sales and exchanges of capital assets sold after May 5, 2003, and through December 31, 2007, your long-term capital gains tax rate is 5 percent.
- For sales and exchanges in 2008, your long-term capital gains tax rate is 0 percent.
- Beginning in 2009, your long-term capital gains tax rate will again be 5 percent for capital assets that you owned for more than 12 months.

If you're in an income tax bracket higher than 15 percent (this would include most real estate investors):

- For sales and exchanges of capital assets sold after May 5, 2003, your long-term capital gains tax rate is 15 percent.

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The tax rate for short-term capital gains is subject to the same tax bracket as your ordinary income tax bracket (currently between 10 and 35 percent). For C corporations, the tax rate for all capital gains is the same as the corporation's tax rate for ordinary income (currently taxed between 15 and 39 percent).

Will the Capital Gains Tax Be Repealed in 2009 and Future Years?

We are frequently questioned as to whether it is wise to engage in tax planning methods now with the expectation that the capital gains tax for those in the lowest tax bracket will be repealed in 2009 (as it was in 2008), as stated previously. For those of you in lower tax brackets, it might look as though you will be able to sell your appreciated capital assets and pay no tax if you sell the assets in 2009.

However, do not get too excited. These tax provisions applied only to 2008. It is extremely doubtful that these changes will be made permanent for any tax years after 2008, especially due to the current large federal budget deficits. This is certainly the case for 2009, for which the 5 percent rate for those in the lowest tax brackets will apply. Furthermore, the tax laws will likely revert to the way they were before the passage of the 2003 Tax Act or that new provisions will be implemented. Therefore, we would not count on the 0 percent rate to remain the law for any years after 2008, especially if the large federal budget deficits continue.

Holding Periods for Capital Assets

To determine whether your capital asset will receive the preferential long-term capital gains tax treatment upon its sale, you first need to determine its holding period. Long-term capital gains, as stated previously, are taxed at a much more favorable rate than the sale of noncapital assets or short-term capital assets.

The following six steps will assist you in determining the overall holding period:

1. Determine how the property was acquired. If it was acquired as a regular purchase, follow the formula stated in Step 2. If the property was acquired as a gift, inheritance, or exchange, special holding periods will apply, as explained in Steps 4 and 5.
2. Count the time you have held the property. Start counting on the day after acquisition and stop counting on the date of the disposition. For real estate, the closing day of the purchase does not count, but the closing day of the sale does count.⁴
3. Determine whether the holding period is short term or long term based on the preceding counting method and the explanation that follows:
 - a. *Long term.* You must hold the property for at least one year and one day.⁵ Be careful here, because if you hold the property for only one

year, you will be taxed at your ordinary income tax rate (currently up to 35 percent). If you keep the property for one year and one day, you will receive the much more favorable long-term capital gains rate (maximum of 15 percent).

- b. *Short term.* Property held less than one year and one day, as calculated in the previous step.

Example

Jake buys a house on December 1, 2009, and sells it on December 1, 2010. He cannot count December 1, 2009, as the date of acquisition, so his holding period is only one year. Thus he will be taxed at his regular income tax rate because he did not hold the property for at least one year and one day.

4. *Inheritances.* Taxpayers get a break here because the gain is categorized as long term no matter how long the capital asset was held by the deceased.⁶
5. *Gifts.* If you receive your capital asset as a gift, the holding period is transferred from the donor (the person giving you the gift) to the donee (you).⁷ This means that your holding period is added to the donor's holding period to determine whether it is long term or short term.

Example

If your mom gifts you a piece of property and she has held the property for 10 years, your holding period on receipt of the property is 10 years. If you sell the property one day after receiving it, it is taxed as a long-term capital gain.

6. *Transfers.* If the property was acquired via an exchange or transfer (for our purposes, a like-kind exchange), it has the holding period of the property transferred.⁸

Example

Michael owns a rental property and has held it for five years. It has also been rented for each of these years. Michael decides to use a 1031 exchange (a like-kind exchange) and exchange this property for a new rental property. His holding period in the newly acquired property is now five years, with one exception: This holding period only applies up to and including the transferred property's basis!

What does this mean? See the next example.

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Example

This scenario involves the same facts as the previous example except that Michael's old property has a basis of \$200,000. The newly acquired property is purchased for \$300,000. Because the new property has a higher basis than the old property, the long-term holding period will only apply to the \$200,000 of basis. The other \$100,000 of new basis will start a new holding period beginning on the date of closing.

Tax Tip

Make sure you are including *all* your expenses related to the sale of your property. See the discussion later in this chapter for a list of expenses to include as part of your cost basis to help you offset your gain. If you miss some expenses, you will overpay your taxes, which we do not recommend!

Example

John owns a piece of real estate that he purchased and has rented since August 1, 2009. John decides to sell the property on August 2, 2010, for \$250,000. His adjusted basis in the property (or his cost plus improvements) is \$210,000. John has also taken \$4,000 of depreciation over the past year on his tax return. John's gain and tax are calculated as follows:

Sale price:	\$250,000
Less:	
Adjusted basis (includes):	\$210,000
Purchase price:	(\$180,000)
Improvements:	(\$ 10,000)
Selling expenses:	(\$ 10,000)
Purchase expenses:	(\$ 10,000)
Plus depreciation:	\$ 4,000
Equals gain:	\$ 44,000
	(\$250,000 - \$210,000 + \$4,000)
Long-term capital gains tax rate:	\$ 6,000 (15% of \$40,000)
Depreciation recapture (discussed later):	\$ 1,000 (25% of \$4,000)
Total tax:	\$ 7,000

If John had made the mistake of selling his property on August 1, 2010, he would have ended up paying tax at his ordinary income tax rate. If John's tax rate is 35 percent, he would have ended up paying taxes of \$15,400 on the sale, instead of the much lower \$7,000. As you can see, this would have caused John to pay an additional \$8,400 in tax simply because he failed to hold onto the property for a few more months before selling!

Multiple Holding Periods

Real estate can sometimes have more than one holding period. This often applies to real estate developers who acquire land and then construct a building. In this case, there are two holding periods: one for the land and one for the building. The building may also have multiple holding periods if multiple portions are completed (Revenue Ruling 75-342).

Tax Tip

C corporations do not receive the favorable long-term capital gains rates on the sale of capital assets held one year or more. Thus we do not advise our real estate investor clients who are holding property on a long-term basis (for investment purposes) to hold such property in a C corporation. However, C corporations may be a beneficial business entity for dealer property, which is discussed in Chapter 5.

What Is "Basis"?

Understanding the rules concerning *basis* is important to help you determine your overall gain or loss on the disposition of property, including capital property. The higher your basis in relation to the sales price of the property, the less tax that will be calculated on the sale. Thus it is important to make sure that all your expenses are properly captured. The following are some important terms and concepts regarding basis issues:

- *Adjusted basis.* Adjusted basis is the original cost or basis of the property, plus any improvements, less any depreciation already taken on the property. Your basis will differ depending on how you acquired the property.
- *Purchased property.* The adjusted basis is your cost in the property (generally the purchase price plus expenses), plus improvements, less depreciation already taken.

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Example

Jake purchased residential real estate for \$350,000. He has also put an additional \$50,000 in improvements into the property over the years. He has taken \$25,000 in depreciation on his previous tax returns. Jake's adjusted basis is \$375,000 ($\$350,000 + \$50,000 - \$25,000 = \$375,000$).

- *Inherited property.* The basis of property acquired by inheritance is the fair market value on the date of death.⁹ This is commonly referred to as a *step up* in basis.

Example

Jake inherits a house from his mother. On the date of her death, Jake's mother's adjusted basis was \$25,000. The fair market value on the date of death is \$350,000. Jake's adjusted basis is now \$350,000.

Compliance Tip

Capital gains and losses are reported on Schedule D (and attached to Forms 1040, 1041, 1065, 1120, and 1120S). A copy of Schedule D can be found in Appendix A.

For inherited property, it will be necessary to determine the fair market value at the time of death to receive the step up in basis. *Fair market value* is defined as the price that property would sell for on the open market. It is the price that would be agreed on between a willing buyer and a willing seller, with neither being required to act and both having reasonable knowledge of the relevant facts.¹⁰ For a taxpayer selling the property immediately after receiving it from an estate, the fair market value will usually be the sales price. However, if you do not sell the property immediately after you inherit it, it will generally be necessary to have an appraisal of the property done at the time of death. You can use a person other than an appraiser, such as a real estate agent, but we recommend that you pay for a formal appraisal, since this will provide you with much better ammunition in the event of a tax audit.

Certain appraisal guidelines must be followed to determine the fair market value of a property.¹¹ Note that appraisals can vary significantly depending on the appraiser you use. You will want to seek out the most aggressive appraisal you can, since this will save you significant tax dollars when you sell the property.

Note that in certain cases, it might not be advantageous to seek out a higher fair market value of the property. This can happen when the higher

fair market value will increase any estate taxes that may be due. See your tax advisor for assistance with this issue, since it can get very complicated if you have competing tax goals.

The basis of property acquired by gift is its basis in the hands of the donor (the person making the gift) right before its transfer to the donee (the person receiving the gift), plus any gift tax paid on the gift.¹² This is commonly referred to as *carryover basis*. Property received as a result of divorce or marriage is also considered a gift under the Tax Code.¹³ You do not get a step up in basis when you receive property via a gift.

Tax Tip

The future of the step up in basis for inherited property is in jeopardy if the federal estate tax is repealed. This development will need to be monitored as any estate tax legislation is considered in the near future.

Example

Jake's mother gives him a house worth \$350,000. Jake's mother's adjusted basis right before the gift is \$25,000. Jake's adjusted basis is \$25,000.

For transferred property/1031 exchange property, the basis of the newly acquired property is the same as the relinquished property, decreased by the "boot" received (usually money or other property) and increased by the amount of gain the taxpayer recognizes. The concepts of boot and other 1031 exchange issues¹⁴ are discussed in detail in Chapter 4.

Example

Jake exchanges, via a 1031 exchange, a rental building for another rental building. He has received no boot and he does not realize any gain on the exchange. His adjusted basis in the relinquished property is \$100,000. The fair market value of the replacement property is \$110,000. Jake's basis in the replacement property is \$100,000, the same as his basis in the relinquished property. There is no step-up basis when a 1031 exchange is done.

Again, your basis in the property ultimately determines how much tax you will (or will not) have to pay upon its disposition. You also must know the property basis for determining how much depreciation you can take for any given year on a rental property. The higher the basis, the more of a depreciation deduction you will receive on your tax return for the year and the less in taxes you will be obligated to pay.

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You can use the following formulas to determine your adjusted basis for real estate. For your convenience, we have included these formulas in Appendix B for you to make copies and utilize each time you need to determine your basis.

Adjusted basis (short formula)

Original purchase price:	\$ _____
Plus purchase expenses (see long formula below):	\$ _____
Plus improvements:	\$ _____
Less depreciation allowed:	\$ _____
Equals adjusted basis:	\$ _____

Adjusted basis (long formula)

Original purchase price:	\$ _____
Plus purchase expenses:	\$ _____
Cash paid	
Mortgages created	
Settlement or HUD costs (see below)	
Mortgage interest not taken as expense	
Real estate taxes not taken as expense	
Legal fees (not related to HUD)	
Broker fees (not related to HUD)	
Travel expenses	
Meals and entertainment expenses	
Auto expenses	
Supplies	
Advertising	
Construction costs	
Repairs	
Any expenses related to the purchase not noted above!	
Plus improvements:	\$ _____
Less depreciation allowed:	\$ _____
Equals adjusted basis:	\$ _____

Settlement, Closing, or Housing and Urban Development (HUD) Costs

Closing costs (commonly referred to as *settlement costs* or *HUD costs*) are certain costs incurred due to the acquisition of real estate. The tax treatment of closing costs depends on the type of cost involved. Certain costs will be entirely deductible; others will not be deductible at all. Some closing costs will get rolled into your basis in the property, but others will be depreciated or amortized. It is important to know which costs are deductible so that none are missed, since missed expenses typically mean a higher overall tax bill than is necessary. Generally, the costs listed here will be deducted on either Schedule E (rental property income and expenses) or on Form 4562 (depreciation and

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amortization). Both of these forms are supplied in Appendix A. If the purchase involves your personal residence, the only expenses that are currently deductible (on Schedule A) are mortgage interest and real estate taxes. The following is a list of common items you will see on your closing statement and the tax treatment of each.

Item	Buyer Closing Costs	Where to Deduct Buyer Closing Costs	Seller Closing Costs	Where to Deduct Seller Closing Costs
Commissions	Added to basis	Form 4562	Sales expense	Schedule D or Form 4797
Items Payable in Connection with the Loan				
Loan origination (points)	Amortized	Form 4562	Sales expense	Schedule D or Form 4797
Loan origination (points)	Amortized	Form 4562	Sales expense	Schedule D or Form 4797
Appraisal fee	Amortized	Form 4562	Sales expense	Schedule D or Form 4797
Other loan costs	Amortized	Form 4562	Sales expense	Schedule D or Form 4797
Items Required by the Lender to be Paid in Advance				
Interest	Deductible	Schedule E or Form 8825	Deductible	Schedule E or Form 8825
Mortgage insurance (PMI)	Amortized	Form 4562	Sales expense	Schedule D or Form 4797
Hazard Insurance	Deductible	Schedule E or Form 8825	Deductible	Schedule E or Form 8825
Reserves Deposited with Lender				
Reserves	Not deductible	—	Not deductible	—
Title Charges				
Title charges	Added to basis	Form 4562	Sales expense	Schedule D or Form 4797
Government Recording and Transfer Items				
Recording fee: deed	Added to basis	Form 4562	Sales expense	Schedule D or Form 4797
Recording fee: mortgage release		Form 4562	Sales expense	Schedule D or Form 4797
Tax stamps/transfer tax	Added to basis	Form 4562	Sales expense	Schedule D or Form 4797
Additional Charges				
	Added to basis	Form 4562	Sales expense	Schedule D or Form 4797
Pest inspection	Added to basis	Form 4562	Sales expense	Schedule D or Form 4797
Closing fee	Added to basis	Form 4562	Sales expense	Schedule D or Form 4797

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Tax Tip

If you see "POC" on your closing statement, this means you have paid items outside the closing. These items may or may not be deductible, but you should check with your tax professional to determine the tax status of such items.

Note that real estate dealers treat their costs from buying and selling real estate, as shown on the closing statement, as ordinary expenses incurred from the sale and purchase of real estate.

In the table, we have used certain terms in the buyer and seller columns. For purposes of this chart, "Added to basis" means that the item will be added into the overall cost of the property. For rental real estate, these costs will be included in the depreciable basis. The current depreciable rate for residential rental real estate is 27.5 years, whereas commercial rental real estate is depreciated over 39 years. For residential real estate held for resale, these costs will be added to basis to offset any capital gain on the disposition of the property.

"Sales expense" means that the seller will include these costs as part of the costs to sell the property, and these costs will offset any gain the seller receives on the disposition of the property.

"Deductible" means that these costs are fully deductible for a rental property on the appropriate line item on Schedule E, or on Form 8825 for an entity holding title to the real estate. Copies of these forms are included in Appendix A. Otherwise, these costs are added to the basis of the property.

"Not deductible" means that these costs are neither added to basis nor deductible at the current time for rental property. These items (such as real estate taxes or insurance) are usually held in escrow and are held for the benefit of the owner. When these items are actually paid, they become fully deductible items.

Compliance Tip

Depreciation for rental real estate is calculated on Form 4562, which is then transferred to Schedule E (for rental real estate held in your personal name or in a single-member LLC) or to Form 8825 (for rental real estate held in an entity such as a partnership).

"Amortized" means that these costs are taken over the life of the loan. Make sure that you indicate to your tax return preparer the term of your loan, or the professional could wrongly assume that you have a 30-year mortgage term when

you actually have a 15-year term or less. This error is common and results in a lower overall tax deduction every year. Amortized expenses are calculated on Form 4562 and then transferred to the applicable Schedule E or Form 8825. For amortizable costs with respect to any startup expenses incurred prior to October 22, 2004, you are allowed to deduct these costs over a five-year period. For amortizable costs incurred after October 22, 2004, you can deduct \$5,000 in the first year and the remaining amount over the next 15 years.¹⁵

Tax Tip

Acquisition points and other loan costs are amortized over the life of a loan. However, when the loan is paid off (as is commonly done through a refinance or when the property is sold), the points and other loan costs that have not yet been deducted can be claimed in full in the year paid. Only amortized loan costs and points (and not costs added to your basis or otherwise not deductible) are eligible to be fully written off in the year of refinance. Note that you must refinance with a different lender to take advantage of this deduction.¹⁶

Example

Emma placed a piece of rental property in service in 2007. She paid \$2,000 of points to obtain the loan. In 2007, 2008, and 2009, she deducted as amortization \$75 per year for a total of \$225. In 2010, she refinanced the loan with a different lender. The remaining \$1,775 of points would be fully deductible in 2010, the year the loan is paid off through the refinance. If she paid any points on the new loan, a new amortization period would begin.

Acquisition points and other loan costs are amortized over the life of a loan. However, when the loan is paid off (as is commonly done through a refinance or when the property is sold), the points and other loan costs that have not yet been deducted can be claimed in full in the year paid. Only amortized loan costs and points (and not costs added to basis or not deductible) are eligible to be fully written off in the year of refinance. Note that you must refinance with a different lender to take advantage of this deduction. Delete this? Same as above.

Gain or Loss Calculation

Now that you understand what is or is not a capital asset as well as comprehending the basis and holding periods, let's look at how you determine the calculation

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of the gain or loss on the sale of property, including capital property. A quick and simple formula for calculating gain or loss on the disposition of property is as follows:

Sales price:	\$ _____
Less sales expense:	\$ _____
Less adjusted basis:	\$ _____
Original purchase price:	\$ _____
Plus purchase expenses:	\$ _____
Plus improvements:	\$ _____
Less depreciation allowed:	\$ _____
Equals net gain or loss:	\$ _____

Let's look at an example to illustrate the formula.

Example

John purchases a piece of rental real property on December 15, 2002, for \$150,000. His closing costs on the purchase were \$2,000. He has put \$15,000 of improvements into the property over the years. He has taken \$5,000 in depreciation during this time as well. John sells the property for \$275,000 on June 17, 2009. His closing costs on the sale are \$4,000. His gain is calculated as follows:

Sales price:	\$275,000
Less sales expense:	\$ 4,000
Less adjusted basis:	\$162,000
Original purchase price:	\$150,000
Plus purchase expenses:	\$ 2,000
Plus improvements:	\$ 15,000
Less depreciation allowed:	\$ 5,000
Equals net gain or loss:	\$109,000

John's net gain is \$109,000. He has held the property for longer than one year, and therefore he will pay tax at the long-term capital gains rate of 15 percent. He will also pay tax on the depreciation recapture at a rate of 25 percent. (Depreciation recapture is discussed in the next section.) His overall tax bill will be \$16,850, an amount that is calculated by taking 15 percent of his gain of \$104,000 (without the depreciation) and 25 percent of the \$5,000 of depreciation claimed.

Sales and Exchanges Between Related Parties

If you sell or exchange property with a related party such as your child or parent, special rules may apply to the tax treatment of your sale. For instance, if you sell a capital asset to a related party, the gain may not be taxed as capital gain but rather as ordinary income. Losses on the sale of a capital asset sold to a related party may also not be deductible.

If you sell or exchange depreciable property (such as a rental property) to a related party and it results in a gain, the gain is ordinary income if the sale is either directly or indirectly between the following:

- A person and the person's business entity in which there is a controlling interest.
- A taxpayer and any trust in which the taxpayer is a beneficiary.
- An executor and a beneficiary of an estate, unless the sale is in satisfaction of a pecuniary bequest (a specific bequest in the will).

A loss on the sale or exchange (either directly or indirectly) of property between related parties is not tax deductible. The following are considered related parties for purposes of these rules:

- Family members such as brothers, sisters, spouse, lineal descendants, and ancestors.
- An individual and a corporation if the individual owns 50 percent or more of the stock in the corporation.
- Two business entities that are members of the same controlled group or in which the same persons own 50 percent or more of the value of the stock or interest of the business entity.

If you receive property from a related party who had a loss (either through a purchase or exchange) and you later sell the property, you will recognize gain only up to the amount that the gain exceeds the original loss to the related party.

Example

Your mother sold a rental property to you for \$150,000. Your mother's adjusted basis was \$200,000. Her loss of \$50,000 is not deductible for her due to the related-party rules. You later sell the property for \$250,000. Your realized gain is \$100,000 (\$250,000 sale price less adjusted basis of \$150,000). Your recognized gain, however, is only \$50,000 (\$100,000 – \$50,000) because you would get the tax benefit of your mother's \$50,000 loss.

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Sales of Business Property (Noncapital Property)

As discussed, you must classify the property you sell as either capital property or ordinary business property, and you must also classify your gains and losses as either capital or ordinary (and your capital gains as either short term or long term). We have discussed the sale of capital property; now let's discuss the sale of business property.

In general, business property fits into one of three possible categories: Section 1231 property, Section 1245 property, or Section 1250 property. We discuss each of these types of property in the following sections.

Section 1231 Property

Property used in a trade or business is called *Section 1231 property*. Like a capital asset, 1231 property is entitled to favorable capital gains treatment upon its sale or disposition. Section 1231 property receives long-term capital gains tax rates if there is a gain (with the exception of any depreciation that must be recaptured), but it receives ordinary loss tax rates if there is a loss.

The following common property types qualify as 1231 property (not exclusive):

- Rental real estate.
- Business real estate.
- Depreciable personal property used in a real estate activity.
- Any property used in your business.
- Leaseholds.

Note that dealer property and inventory used in the ordinary course of your business are not considered 1231 property.¹⁷ Also, be aware that the portion of the gain from the sale of 1231 property that is subject to depreciation recapture, as discussed in a moment, is taxed at a higher tax rate of 25 percent.

Example

John sells the following property used in his rental real estate business and that he held for at least one year and one day:

Rental building and land:	\$20,000 (gain)
Washer and dryer:	\$ 100 (gain)
Computer:	\$ 300 (gain)
Refrigerator:	(\$ 1,000) (loss)
Total gains:	\$20,400
Total losses:	(\$ 1,000)

Because the overall gains exceed the overall losses, each gain and each loss is treated as a long-term capital gain and a long-term capital loss. If the

losses had exceeded the gains, the entire loss would be treated as an ordinary loss and would be deductible in full and not subject to the \$3,000 limitation per year on capital losses.

DEPRECIATION RECAPTURE

If you sell depreciable or amortizable property and have a net gain, your gain might be subject to ordinary income tax rates. *Depreciation recapture* is subject to a separate tax calculation and does not receive the more favorable long-term capital gains rates. Any gain attributable to depreciation recapture is subject to a top tax rate of 25 percent. Section 1245 and 1250 (in some cases) property is subject to depreciation recapture as well, since these types of property, discussed next, are depreciable or amortizable property.

Example

John sells rental property he held for at least one year and one day at a gain of \$20,000. Of this \$20,000 gain, \$5,000 was previously taken as depreciation.

The taxes are calculated as follows:

	Net Gain	Tax Rate	Tax
Total gain:	\$20,000		
Gain attributable to prior depreciation:	\$ 5,000	25%	\$1,250
Remaining 1231 property gain:	\$15,000	15%	\$2,250
Total taxes due:	\$ 3,500		

Section 1245 Property

Any gain on the sale of 1245 property is treated as ordinary income to the extent of the depreciation allowed or allowable on the property. *Section 1245 property*, for our purposes, is property that is depreciable or amortizable and is tangible or intangible personal property (such as a car or a computer). Section 1245 property does not include any buildings or their structural components. The gain on the sale of 1245 property is the lesser of the following:

- The depreciation and amortization taken or allowable on the property.
- The gain realized on the disposition.

The following types of depreciable and amortizable property are subject to depreciation recapture¹⁸:

- Ordinary depreciation deductions.
- The 30 percent special depreciation allowance for property acquired after September 10, 2001.

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- The 50 percent special depreciation allowance for property acquired after May 5, 2003.
- Property for which a Section 179 expense deduction was elected.
- Amortization for:
 - Lease acquisitions.
 - Lessee improvements.
 - Pollution control facilities.
 - Section 179 intangibles.

Example

In 2005, you purchased a vehicle that cost \$25,000 for your real estate business. You took \$10,000 of depreciation over the years. You sold the vehicle in 2009 for \$22,000. You figure your gain and depreciation recapture as follows:

Amount realized:	\$22,000 (sale price)
Basis:	\$25,000 (cost)
Depreciation taken or allowable:	\$10,000
Adjusted basis (original basis less depreciation):	\$15,000
Gain realized (adjusted basis less amount realized):	\$ 7,000
Gain taxed as ordinary income (lesser of depreciation taken or gain realized):	\$ 7,000

You should be aware that the depreciation actually taken or allowable is subject to depreciation recapture. If you failed to take any depreciation on the property, you still must figure the depreciation in your calculation. Thus we recommend amending your prior returns, if possible, to capture the depreciation deductions that should have been taken in earlier years. If you are going to be taxed on the depreciation either way, you might as well get the tax benefits!

Section 1250 Property

If you sell *Section 1250 property*, the gain is taxed as ordinary income to the extent of additional depreciation allowed or allowable on the property sold. Section 1250 property includes the following:

- All real property subject to depreciation and that is not 1245 property.
- Leaseholds of land.

ADDITIONAL DEPRECIATION

If Section 1250 property is held longer than one year, the additional depreciation is the actual depreciation adjustments that are more than the depreciation figured using the straight-line method. If the property is held one year or less, all the depreciation is additional depreciation. This is not as confusing as it sounds, as we will hopefully demonstrate.

There will not be additional depreciation if the following rules apply to the property you sold:

- You used the straight-line method on the property, you held it longer than one year, and you did not take the special 30 percent or 50 percent depreciation deductions on Qualified Liberty Zone property.
- The property was residential rental property placed in service after 1986, you held it longer than one year, and you did not take the special 30 percent or 50 percent depreciation deductions on Qualified Liberty Zone property.

Example

Tom purchased a residential rental building for \$25,000 in 2000. He takes depreciation of \$2,500 over the years using the straight-line method of depreciation. Because Tom has held the property longer than one year, because he has used the straight-line method of depreciation, and because the property is residential rental property, Tom has no additional depreciation to report.

Example

Tom gives his daughter a residential rental building for which Tom's adjusted basis is \$50,000; over the years Tom has taken \$15,000 for depreciation. Of this amount, \$1,000 is additional depreciation. After the gift, his daughter takes a carryover basis, including the additional depreciation. She then sells the property. Her additional depreciation is \$1,000 and taxes are unfortunately due on this amount.

There are many other unusual instances for which your basis may need to be computed differently than in any of the examples we have provided in this chapter. We strongly suggest that you obtain IRS Publications 554 and 551 prior to any sales so that you can compute the overall tax ramifications with respect to any potential sale. This way, you will not receive any unplanned tax liabilities come April 15.

If you fail to make payments you owe on a loan or mortgage on a property you own, the lender may foreclose on the property or repossess it. The foreclosure or

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repossession is treated as a sale or exchange for which you may realize gain or loss. You may also realize ordinary income, which may be taxable from cancellation of debt if the loan balance is more than the fair market value of the property.

The gain or loss on a foreclosed property is the difference between your adjusted basis and the amount realized. If you are not personally liable for repaying the loan (a "nonrecourse" loan), the amount you realize as income includes the full canceled debt, even if the fair market value of the property is less than the canceled debt amount. If you are personally liable for the loan (a "recourse" loan), the amount realized on the foreclosure or repossession does not include the canceled debt. However, if the fair market value of the transferred property is less than the canceled debt, the amount realized includes the canceled debt up to the fair market value of the property. You must realize ordinary income from the canceled debt for the part of the debt that is more than the fair market value.

Cancellation of Debt

If property is repossessed or foreclosed on and there is a loan secured on it for which you are personally liable, you generally must report as ordinary income the amount by which the canceled debt is more than the fair market value of the property. Report this income on Line 21 of your Form 1040. Businesses report this income as "other income" on their tax return. The lender should send you a 1099-C showing the canceled debt amount. If the lender does not send you a 1099-C, be advised that this usually means the lender has reserved its right to sue you personally on the deficiency (this will usually happen when the lender has sent you a 1099-A instead of a 1099-C).

Please be aware that recent legislation has removed most debt cancellation income if it originated from debt secured by your personal residence and was incurred in the acquisition, construction or substantial improvement of your personal residence. In this case, the first \$2 Million (\$1 Million for married filing separate taxpayers) of debt cancellation is tax free. This will certainly assist taxpayers who have lost their main home to foreclosure. We expect to see many more tax changes in this area due to current economic conditions and, as such, we highly recommend that you consult with your tax advisor to determine if any changes have been made to this area of the tax law.

Tax Tip

There is an exception to the rule of claiming cancellation of debt as income. This rule applies if you are bankrupt or insolvent, if the debt is qualified personal residence debt, or if the debt is qualified real property business or farm debt. IRS Form 982 will need to be filed and attached to your tax return to claim this exception. Please also note that some states do not allow this exception. Consult your tax advisor for details.

Conclusion

A thorough understanding of capital gains is essential for all real estate investors. It is counterproductive to spend much time and energy maximizing your overall profits, only to give too much of the profits back to the IRS and state taxing agencies. Although some of the concepts discussed in this chapter can get complicated, it is important for you to understand how you can compute your overall cost basis, along with how you treat expenses at the closings and while you own the property. An accurate estimation of these numbers will also help you avoid any unpleasant surprises come tax time.

Finally, proper tax planning concerning capital gains has helped many of our clients reduce their overall tax bills to the absolute legal minimum, a goal that all of us consider especially worthwhile.

