CHAPTER 12 - TAX CONSIDERATIONS

Notes:

PROPERTY TAX COMPUTATIONS

Real estate taxes are *ad valorem* taxes; that is, tax is assessed *according to the value of the property*. The tax assessor sets the value for each non-exempt property. Assessed value could be market value or a percentage of market value. Many states have state boards of equalization that ensure that valuations are set uniformly throughout the state. Property owners can appeal assessments (but not the tax rate) within a specified period of time through an appeal board. The total of the assessed valuations is known as the assessment roll, assessment tax base or tax roll.

Tax Rate. To determine the tax rate, the taxation authority divides the budget needs by the assessment roll:

$$\frac{\text{Budget Needs}}{\text{Assessment Roll}} = \text{Tax Rate}$$

For example, if a community needed $850,000 and had a tax base of $20,000,000, the tax rate per dollar of assessed valuation would be $.0425:

$$\frac{850{,}000}{20{,}000{,}000} = .0425$$

Tax rates are often expressed in **mills**. A mill is 1/10th of a cent, or $.001. The tax rate of $.0425 per dollar of evaluation could be expressed as 42½ mills. To determine the taxes, simply multiply the tax rate by the assessed valuation:

Assessed Value x Tax Rate = Annual Tax Amount

Using the .0425 per dollar rate, the taxes on a home assessed at $80,000 would be $80,000 times .0425, which equals $3,400. Assessed valuation is not necessarily the same as market value; it could be a much lower or even a higher figure.

INCOME TAX CONSIDERATIONS

The use of the property generally drives the tax consequence and reporting of its ownership. Common purposes for which property is held include personal use, business operations or investment purposes, and these purposes may change and intermingle during the life cycle of ownership. The deductibility and reporting rules are also tied to the method of accounting used by the taxpayer. Under the "**cash basis**" of accounting benefits (income and expenses) are considered reportable or deductible when "constructively received" in cash or equivalent form. The "**accrual basis**" generally applies to businesses with salable inventories. Under the accrual basis, income is generally reported when the right to receive it occurs. Expenses are likewise deductible when they are incurred, that is, when all events have occurred that fix the amount of the item and create a liability for the taxpayer to pay it. The purpose of accrual accounting is to better match the reporting of income with the associated expenses of generating it.

All gains from the sale of property are taxable. Losses from the sale of business or investment property can be used as deductions against other income, but a tax loss cannot be taken for the sale of a person's residence.

Determining Gain

Amount of taxable gain is computed by deducting the seller's adjusted cost basis or book value from the net sales price. **Adjusted cost basis** is *original cost + improvements - depreciation*.

Although **improvements** (*something new to enhance the value*) will increase the cost base, repairs will not. Repairs are considered operating expenses and are deductible expenses for income and investment property. For example, if a home originally cost $100,000 and the buyer spent $10,000 in improvements, the adjusted cost basis would be $110,000:
$100,000 Cost + $10,000 Improvements = $110,000 Book Value (Adjusted Cost Basis)

If the owner then sold the property for $150,000, there would be a taxable gain of $40,000, the difference between sales price and book value (adjusted cost basis). The seller's sales costs would reduce the taxable gain. As an example, if the seller incurred commission and closing costs of $8,000, the gain in the example above would be reduced to $32,000.

Exemption of Gain - $250,000/$500,000 Gain Exclusion

Pre-1997, a homeowner could merely *defer* (postpone) paying tax on gains from the sale of his or her residence if within two years of the sale the homeowner purchased a new home costing the same as or more than the sales price of the former home. The homeowner could not use this procedure more than once in a two-year period. In addition, the IRS *formerly* had a 55-or-older exclusion of up to $125,000 in gain. The 55-or-older homeowner could exclude up to $125,000 in gain once in a lifetime.

Q&A From 1997 through 2008, the federal government *excluded* $500,000 from capital gains tax for profits on the sale of a principal residence by married taxpayers who file jointly. Taxpayers who file singly were entitled to a $250,000 exclusion, with only the following restrictions on this exclusion: 1) the exemption could be used repeatedly; 2) the homeowners need to occupy the property as their residence for at least two of the previous five years; and 3) the $250,000/$500,000 exclusion was not already used for the prior sale of any residence in the previous two year period. For most homeowners, the net result of the law was that they would never pay capital gains tax on the sale of their homes.

Starting in 2009, Homeowners got less of a capital gains tax break when it came to the sale of vacation homes, second homes and certain rental properties.

Because savvy homeowners often used this capital gains exemption to sell their main home, then move into a vacation home for two or more years and sell that home to reap a similar tax break - The Housing and Economic Recovery Act of 2008 closed the loophole.

Now when an owner sells a vacation home or other secondary residence, *the IRS will calculate the amount of capital gains to be excluded from the sale based on* ***the ratio of time after 2008 that the home was used as a second home or rental property to the total time the home was owned*** (in IRC language, “qualified” vs. “non-qualified” use). Now taxpayers will be eligible for a calculated *percentage* of the $250,000/$500,000 exclusion rather than the full amount. (If they want to sell a second – rental – home, the rule also applies, as well as to a former vacation home converted to a primary residence.)

> *For example*, the Smiths purchased a second home in 2007. They continued to use it as a rental home during 2009 through 2013, and then they use the home as a primary residence during 2014 through 2018, after which they sell it. Only 50% of the capital gains from the sale of the home will be tax free (up to the $500,000 exclusion) since the home was a primary residence for only 50% of the time after Jan. 1 2009.

Buying Expenses. Certain settlement and closing costs paid by a buyer may be deductible, capitalized (added to the cost or “basis” of the property) or of no tax benefit. The deductibles generally include real property taxes and certain points for the purchase or construction of a principal residence. Non-deductible items generally include other settlement costs such as appraisal fees, notary fees, VA funding fees, points not separately paid for by the borrower at closing for property improvements (these are generally deducted over the life of the loan), title insurance, survey costs, legal fees, loan origination fees and other similar costs. The non-deductible items are added to the basis of the property and will ultimately reduce the gain or increase the taxpayer’s loss in a subsequent sale. These gains or losses may be excluded at the time of next sale or deferred in certain circumstances until the final sale of a residence.

Refinancing. Because there is no tax until there is a sale without a qualified replacement dwelling, an owner can refinance a property, taking cash out and delay paying taxes on the cash proceeds until a sale occurs.

Income Tax Deductions (Homeowners)/Interest. Interest paid on home purchase loans for a principal residence and one second home is deductible, provided the loan balance does not exceed the cost of the residence plus improvements (cost basis), and provided the indebtedness on the principal residence or the principal residence plus the secondary residence does not exceed $1 million. (For debts incurred before October 13, 1987, there is no interest limit.) Interest on home equity loans of up to $100,000 is deductible so long as all combined home loans don't exceed the fair market value of the home(s).

Real Property Taxes. Property taxes are also a deductible homeowner expense. Real property taxes include local, state and foreign real property taxes levied on the value of real property. They do not include "special" assessments for local benefits and improvements such as sidewalks, streets, and water or sewer systems.

Property taxes are generally deductible by the person(s) on whom they are levied in the year they are accrued or paid. In the year of acquisition or sale, both the buyer and seller must apportion among themselves any real property taxes levied for applicable "real property tax year."

Transfer taxes charged by some local tax authorities (i.e., Summit County – 2%) on the sale of a personal residence are not deductible. The person paying this tax may adjust the basis of the property by such amount.

Personal Property Taxes. To qualify for this itemized deduction, the tax must meet three tests: (a) must be charged on personal property, (b) must be based only on the value of the property, and (c) the tax must be charged on a yearly basis, even if collected more or less than once a year.

Q&A **Income Tax Consequences for the Real Estate Licensee.** The real estate licensee is responsible for reporting to the IRS all commissions, fees, and things of value received in the course of their employment, and the licensee's employing brokerage is responsible for reporting all payments to the licensee. Most Colorado brokers treat their agents as Independent Contractors, in spite of the Colorado law (CRS 12-61-101) that could be interpreted as expecting them to be treated as employees, withhold taxes, etc. Here's why:

IRS Publication 3508 indicates that a real estate agent may be treated as an Independent Contractor *if* the brokerage has them sign a written contract (acceptable to the IRS) stating this. Internal Revenue Code Section 3508(b)(1) requires a three-fold test to allow brokerages to treat their agents as ICs, and therefore not have to match FICA taxes, pay unemployment, 401(k), health insurance, etc. First, the person must be licensed; second, the agent's income must be based upon sales and not on hours worked; third, there must be a written agreement between brokerage and agent that specifically states the agent is being treated as a statutory nonemployee (Independent Contractor) for Federal income tax purposes.

This means that the agent (Associate Broker, in Colorado) would be treated as though they are an independent contractor and the agent - not the agency -

would be responsible for all of his or her own taxes. Absent the written contract, the employing broker must withhold and pay income taxes on the employed licensee, including Social Security (FICA) from the employed licensee's commission or paychecks.

Income Tax on Real Estate Transactions Involving Non-Colorado Residents
(Colorado Department of Revenue, Taxpayer Service Division - FYI Income 5, Revised 11/03 – http://www.revenue.state.co.us/fyi/html/income05.html)

GENERAL INFORMATION
Corporations that do not maintain a permanent place of business in Colorado, and nonresident individuals, estates and trusts are subject to Colorado income tax withholding on the sales of Colorado real estate in excess of $100,000. The withholding tax, if required, will be the smaller of:

a) two percent (2%) of the sales price to the nearest dollar, or

b) the net proceeds from the sale. ("Net proceeds from the sale" means the net amount that would otherwise be due to the seller on the settlement sheet.)

The tax is withheld at the time of closing by the title insurance company, its agent, or any other person providing closing and settlement services. The tax is submitted to the Colorado Department of Revenue, where it will be credited to the seller's income tax account as an estimated tax payment. The seller can claim credit for the estimated payment against the income tax liability when filing a Colorado income tax return for the year of the sale. Taxpayers must file a Colorado individual income tax return to claim the estimated payment credit. [C.R.S. 39-22-604.5]

HOW TO FILE THE TAX
The form "Information with Respect to a Conveyance of a Colorado Real Property Interest" (DR 1083) provides information about the transferor (the person or entity that owned the property and is selling it), details of the transaction, reasons for withholding or not withholding tax, and determination of amount of tax withheld. The reverse side of the form provides affirmations that sellers may sign to claim exemption from the withholding.

The form "Payment of Withholding Tax on Certain Colorado Real Property Interest Transfers" (DR 1079) is required when remitting Colorado tax withheld. The form must be filed within 30 days of the date of closing.

NOTE: On the DR 1079, use the name and Social Security number/account number of the taxpayer(s) who will claim the withholding tax on the Colorado income tax return. Do not use the name and account number of the real estate company acting as an agent of the taxpayer(s) in the property sale. Also include the social security number/account number on the check to prevent problems associated with crediting the payment to the proper taxpayer.

WHEN MUST FORM DR 1083 BE FILED?
Except as otherwise specified in the exceptions listed below, a DR 1083 must be completed and filed to report sales of Colorado real property. The form must be filed within 30 days of the date of closing.

WHEN IS THE DR 1083 NOT REQUIRED TO BE FILED?
- The selling price of the property is less than $100,000.
- The seller is an individual, estate, trust, partner or partnership and both the federal Form 1099-S (to report the sales to the Internal Revenue Service) and the authorization, if any, for disbursement of funds from the sale show the seller as having a Colorado address.
- The seller is a government agency.
- The seller is a corporation that is incorporated under Colorado law or is currently registered with the Secretary of State's office as qualified to transact business in Colorado.
- The transferee (the buyer of the property) is a bank or a corporate beneficiary under a mortgage or under a deed of trust, and the property was acquired by foreclosure or by deed in lieu of foreclosure.

WHEN MUST FORM DR 1083 BE COMPLETED AND SUBMITTED WITHOUT A TAX PAYMENT?
Withholding is not required but the Form 1083 must be completed when:
- the 1099-S shows a non-Colorado address but the individual, estate or trust affirms Colorado residency at the time of the sale, or
- the seller, corporation or partnership signs the affirmation of permanent place of business within Colorado, or,
- the seller, who is an individual, signs the affirmation that the property was his/her principal residence immediately prior to the transfer, or
- the seller signs an affirmation that no Colorado income tax will be due on the sale, or
- there would have been withholding, but there were no net proceeds due to the seller, or
- the seller is a partnership, required to file an annual return of income for federal income tax purposes.

By signing the affirmation, the seller assumes responsibility for complying with state income tax laws.

WHEN IS WITHHOLDING REQUIRED?
In all cases other than those listed in the section above, withholding must be made and Forms DR 1083 and DR 1079 must be completed and submitted to the Colorado Department of Revenue.

INVESTMENT PROPERTY DEFINITIONS

Equity. This is an owner's interest in a property. It is the difference between the fair market value and the amount owed against the property (mortgage/trust deeds).

Income. Gross scheduled income is the *scheduled gross based on anticipated 100% occupancy.* **Adjusted gross income** is the *gross income adjusted for an estimated vacancy factor and collection loss*. **Net income** is *what an investor actually realizes from a property, considering all expenses*. While depreciation is considered an expense, principal payments are not.

Cash Flow. Cash flow is net spendable income after all cash expenses are deducted. This would include payments on the principal.

Liquidity. Real estate investments are considered illiquid because of the relatively long time it takes to turn the investment into cash by a sale. Investors can, however, borrow on their equity.

Management. Unlike many securities investments, real estate requires management efforts.

Risk. Some degree of risk is present in all real property investments. Higher leverage investments generally have greater risks.
Appreciation. Real estate values have generally increased more rapidly than the rate of inflation.

Depreciation. Investment property can be depreciated for tax purposes, which can shelter income from taxation. (Homeowners cannot depreciate their personal residences.)

Interest and Taxes. These are tax deductible expenses for income and investment property as well as personal residences.

Leverage. Because real estate purchases are generally financed, an investor is able to purchase property with a value far greater than the down payment. This allows the investor to take advantage of appreciation on the total value, not just the investor's equity. A property purchased with the least amount of the investor’s capital (and the most borrowed money) has the most leverage.

Capital Gains. While repairs are deductible expenses, improvements are added to the owner's cost basis for tax purposes and can be depreciated. Assume an investment property was purchased for $120,000 and the owner spent $38,000 in improvements and took $42,000 in depreciation. The cost basis would be:

Cost	Improvements	Depreciation	Cost Basis

$120,000 + $38,000 - $42,000 = $116,000

If the owner sold the property for $120,000, the same price as originally purchased for, there still would be a $4,000 taxable capital gain:
Sales Price Cost Basis Taxable Gain
$120,000 - $116,000 = $4,000

Capital Loss. While a homeowner who sells at a loss cannot take tax advantage of the loss, owners of investment property can use a capital loss to offset a capital gain from the sale of another property. As an example, if an owner, in one year, sold one investment property at a $100,000 loss and a second investment property at a $100,000 gain, the loss would offset the gain, so no tax would be due. If the taxpayer has no gain in the year of the sale to offset the loss, the loss can still be carried forward and a portion used in succeeding years to offset income for tax purposes.

Tax-Deferred Exchange. By exchanging property, one can defer capital gains. A tax-deferred exchange (**1031 exchange**) must involve *property held for income and investments*, and it must be like-for-like property (real property for real property).

Each party to an exchange keeps the old cost basis, increased by the amount of boot given or decreased by the amount of boot received. **Boot** is *any item of personal property* (usually money) *given to even up a trade*. Debt relief (assuming a lower indebtedness on the property received than on the property given) is considered boot. Boot is taxable as gain to the party receiving it.

An exchange also can be delayed (**Starker exchange**). A seller of property can indicate that the proceeds be held by an escrow holder to purchase another property. The property must be designated within 45 days of the closing, and the completion must occur within 180 days of the closing.

Installment Sales. The income tax is a progressive tax in that as income increases, it is taxed at higher tax rates. By receiving principal from a sale over a number of years, a taxpayer may be able to reduce total tax liability by having income taxed in lower tax brackets. This tax advantage is available for residences as well as for investment property. This benefit is available for total obligations of less than $5 million. Dealers, persons in the business of buying and selling property, cannot spread out their profits and are fully taxed in the year of the sale even though the profit might not be fully received in that year.

Tax Shelter. For business and income property, all expenses are deductible, including depreciation. A tax shelter reduces the income by showing a bookkeeping loss, such as depreciation.

Prior to the 1986 Tax Reform Act, investors could use their real estate losses to shelter other income without limit. Non-cash losses from depreciation could be used to reduce liability. Now real estate losses, which are considered passive losses, can be used only to offset passive income (income from other real estate activities), except:

1. Lower income investors have retained a limited ability to shelter other non-property income, such as wages. Investors with a gross adjusted income of less than $100,000 can use passive real estate losses to shelter up to $25,000 of their other income. For taxpayers having between $100,000 and $150,000 of adjusted gross income, this shelter has been phased out. With each $2 of adjusted gross income exceeding $100,000, the $25,000 limit is reduced by $1. Investors who do not actively manage their property (this includes real estate syndicate investors) cannot use their passive losses to shelter active income.

2. Investors who qualify as real estate professionals can use passive losses to offset other income without limit. Qualification requirements include spending at least 750 hours per tax year in specified real estate-related activities.

(**Note:** *There is no short-answer section for this chapter. Instead, there is a larger quiz, to help students prepare for tax questions*.)