

ULI – San Francisco
“Brownbag” Series
September 18, 2007

Basics of Real Estate Taxation

Jim Lowy
National Tax Department
Ernst & Young LLP
[james.lowy@ey.com/\(415\)894-8602](mailto:james.lowy@ey.com/(415)894-8602)

Any U.S. tax advice contained herein was not intended or written to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under the Internal Revenue Code or applicable state or local tax law provisions.

Agenda

- Objectives
- Source of Tax Rules
- Tax Rates – Corporate vs. Individual
- Taxable Income Basics
 - Basis, Depreciation, Operating Income
- Different Types of Taxpayers
 - Individuals, Corps, Partnerships, LLCs, REITs, Tax Exempts, Foreign Investors
- Tax-Deferred Exchanges [§1031]

Objectives

- Familiarity with very basic concepts
- Familiarity with basic terminology
 - “C” Corps vs. “S” Corps
 - Recapture
 - Pass-Through Taxation
 - Tax Sheltered Cash Flow
 - Phantom Income
 - DREs
 - Exchanges: Starker/Deferred, Reverse, “Boot”

Sources of Tax Rules

- Internal Revenue Code
- Regulations
- IRS Pronouncements (Rulings, PLRs, etc.)
- Case Law
- Tax Treaties
- Secondary Authority

Tax Rates

- Ordinary Income
 - Rents, interest, dividends, compensation, gains from sale of inventory and dealer property, etc.
 - Corporate Rates: Rates up to 35%
 - Individual Rates: Rates up to 35% (15% on dividends)
- Capital Gains
 - Gains from the sale of investment and business assets (non-dealer property)
 - Holding period requirement
 - Corporate Rate (35%)
 - Individual Rates (15% regular and 25% recapture rates)

Tax Rates

- Other Taxes: employment (“stealth”) taxes, state income tax, property tax, transfer tax, sales tax, etc.
- Key Tax Planning Objectives:
 - Timing of Income Recognition
 - Character of Income (Ordinary vs. Capital)

Taxable Income Basics

- Tax Basis
 - Purchase Price
 - Gain on sale = sales price – basis
- Depreciation/Cost Recovery
 - Real Estate Improvements (27.5 yrs. or 39 yrs.)
 - Equipment (5 yrs. or 7 yrs.)
 - Land (0)
- Depreciation Reduces Basis

Tax Income Basics

Depreciation Example

Assume purchase of Embarcadero 4 for \$200 million:

- (1) Allocate price between land (20%?) and building (80%?).
- (2) Depreciate [\$160mm] bldg. over 39 yrs. = \$4mm/year (approx.)
- (3) Adjust property's tax basis downward
 - After 10 years, basis is \$160mm [$\$200 - (\$4 \times 10)$]

Income Tax Basics

Depreciation Example, continued

(4) Sell Property for \$220mm

$$\text{Gain} = \$220\text{mm} - \$160\text{mm} = \$60\text{mm}$$

--\$40mm of gain is recapture gain [25% rate]

--\$20mm of gain is regular capital gain [15% rate]

*15% and 25% rates apply to individuals

Taxable Income Basics

Calculation of Operating Income

Rent		\$20mm
Depreciation	\$ 4mm	
Maintenance	\$ 5mm	
Property Tax	\$ 2mm	
Fees & Misc	\$ 2mm	
Subtotal		<u>\$13mm</u>
NET INCOME		\$ 7mm
Cash Flow		\$11mm

Note: \$4mm of “tax sheltered” cash flow!

Taxable Income Basics

Tax Consequences of Using Leverage

-- Assume \$180mm of \$200mm purchase price borrowed at 5% interest rate (principal due at maturity)

Rent		\$20mm
Depreciation	\$ 4mm	
Maintenance	\$ 5mm	
Property Tax	\$ 2mm	
Fees & Misc	\$ 2mm	
Interest	\$ 9mm	
Subtotal		<u>\$22mm</u>
NET LOSS		\$ (2)mm*
Cash Flow (tax sheltered)		\$ 2mm

*Deductibility of loss may be limited.

Taxable Income Basics

Tax Consequences of Using Leverage, continued

- After 10 years, sell property for \$220mm
(buyer assumes \$180mm debt and pays \$40mm cash)

$$\text{Basis} = \$200\text{mm} - [10 \times \$4\text{mm}] = \$160\text{mm}$$

$$\text{Gain} = \$220\text{mm} [\text{sale price}] - \$160\text{mm} [\text{basis}] = \$60\text{mm}$$

$$\$60\text{mm} [\text{gain}] - \$40\text{mm} [\text{cash}] = \$20\text{mm} [\text{“phantom” income}]$$

Types of Taxpayers

Individuals

- Income, gains and losses reported on individual return [Form 1040]
- Various rules restrict ability to claim losses

Types of Taxpayers

Corporations

- What's a corporation?
- “C” Corporations
 - Corporate Level Tax
 - Consolidated Group
 - Shareholder level tax on dividends (“double tax”)
- “S” Corporations

Types of Taxpayers

Partnerships

- General Partnership vs. Limited Partnership
- Pass-Through Taxation
 - State tax burden for nonresidents
- Benefits of Partnership vs. S Corporation
- Allocations vs. Distributions

Types of Taxpayers

Limited Liability Companies (“LLCs”)

- Multi-Member LLC
 - Treated as a partnership
- Single Member LLC
 - Disregarded entity (“DRE”)
 - Assets treated as owned by single member

Types of Taxpayers

Real Investment Trusts (“REITs”)

- Creature of Tax Law
- Pass-Through Taxation
 - Must distribute income as dividends
 - Shareholders report dividend income
 - Pass through of capital gains
- Complex Rules Regarding:
 - Ownership
 - Nature of assets
 - Nature of income
 - Provision of services

Types of Taxpayers

Tax Exempts

- Special rules apply to charities [§501(c)(3)], pension funds, endowments, etc.
- General tax exemption for rents, dividends, interest and gains
- Exception for leveraged property
- Exception to exception [§514(c)(9)] for pension funds and endowments

Types of Taxpayers

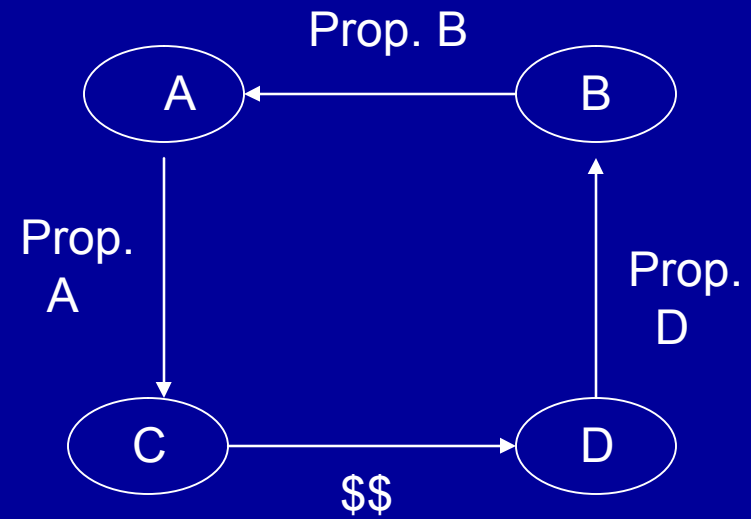
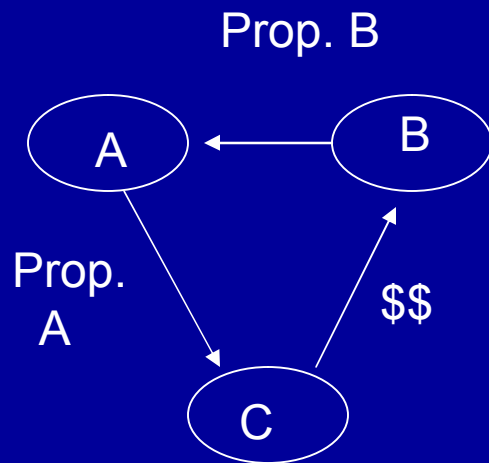
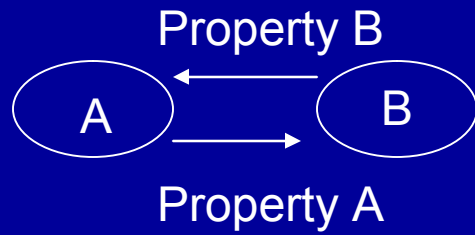
Foreign Investors

- 30% withholding tax paid to IRS by payor on dividends and interest (subject to treaty reduction)
- Generally, regular taxes on operating income (and obligation to file a U.S. return)
- Gains from sales of non-real estate assets generally exempt
- FIRPTA

Section 1031 Exchanges

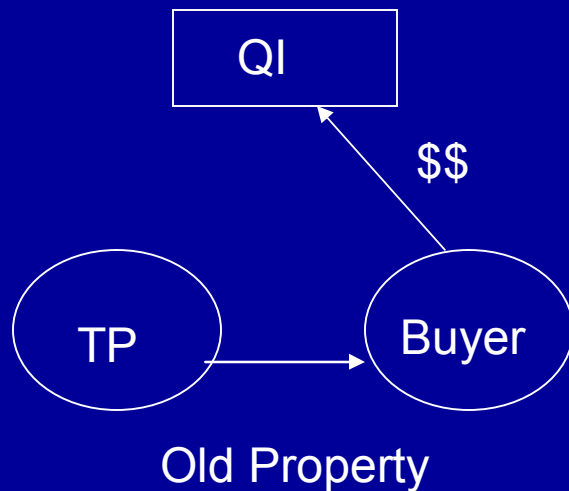
- Exchange one property for another and defer tax
 - Can be 2-, 3-, or 4-sided exchange
- Must be “like kind” property
 - Any kind of real estate
 - Doesn’t apply to stock or partnership interests
- “Boot” is taxable (e.g., any cash received)
- Deferred Exchanges
- Reverse Exchanges

Exchanges

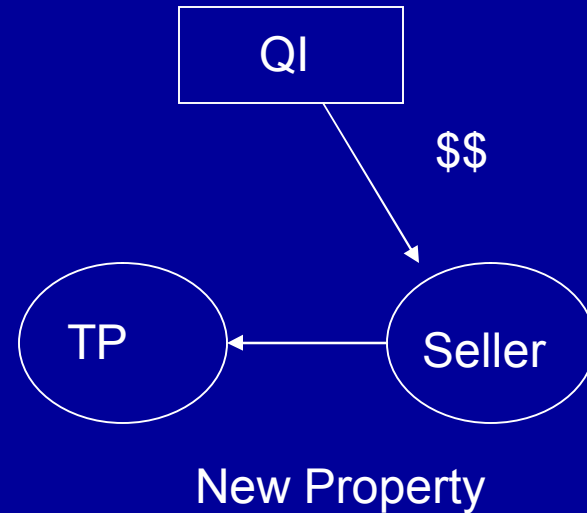


Deferred Exchange

Day 1



Day 180

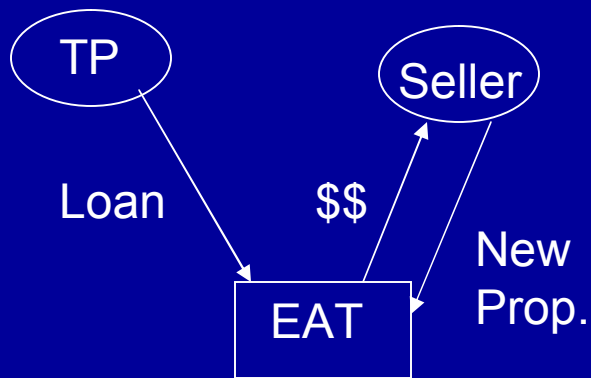


Ready to sell property now but haven't identified replacement property for the exchange.

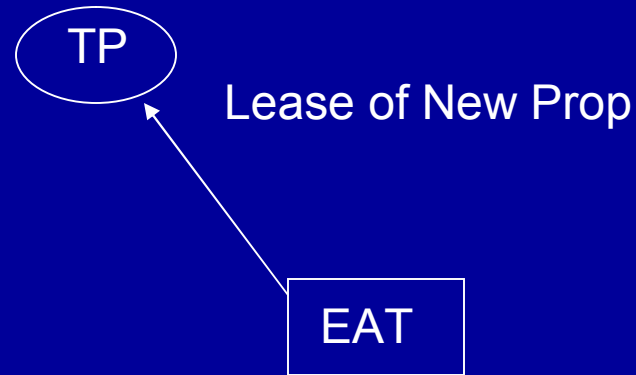
*Simplified. Need to be mindful of detailed rules.

Reverse Exchange

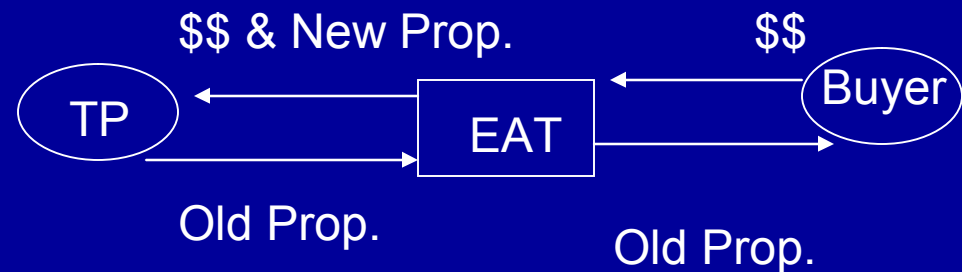
Step 1- Day 1



Step 2



Step 3 – Day 180



Ready to buy property now but haven't identified buyer for old property.

*Again, need to be mindful of detailed rules.