1031 Exchange
Coordinators

THE IMPORTANCE OF KNOWING YOUR BASIS v5

Explaining some of the factors that go into determining your adjusted cost basis on real estate, how it is taxed, and why it is important to know before making any decisions.

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ABSTRACT

This handout is an abbreviated version of our 22 page whitepaper on the subject that is available for purchase by TIC owners and their tax advisors that goes through multiple principles regarding capital gains, tax rates, basis calculation, foreclosure, short sales and non-recourse and recourse debt forgiveness so that a Real Estate owner and their advisors might come to some level of understanding of how taxes work if they need to sell.

INTRODUCTION, PURPOSE, & PROFILE

Introduction

In the past few years the real estate bubble has popped in the United States and investments that seemed satisfactory at the time of purchase now appear in trouble. The trouble stems from not having enough tenants and/or income to provide cash sufficient to pay the monthly debt requirements, much less provide any of promised cash returns. Therefore, lenders are taking unfavorable actions to get the troubled loans off of their books by threatening foreclosure on the property. Owners are forced to short-sell the property at a loss and pay off the debt – if possible. Still worse, some owners must stand by as the property goes into foreclosure or an auction and their equity disappears while substantial phantom income arises in the transaction.

Purpose of Whitepaper

The purpose of this whitepaper is to explain how phantom income and taxable gain arises amidst an economic loss, and why it is important to know adjusted cost basis before any decisions are made.

Introduction to the Problem

The problem can be described in 3 sentences:

1) You have owned the property for a long time or obtained it with a low basis.
2) The value of the property has declined and you have an economic loss.
3) You're wondering what to do with it and whether there is a tax loss or gain.

Income Tax Treatment on a Sale of Real Estate

In general, the income tax treatment on a sale of property depends upon (a) the type of property, (b) the use of the property, (c) the time the property has been held, (d) the manner of the sale, (e) whether gain or loss is realized on the sale, and (f) if it has also be recognized with the IRS.

Basis Notes

It is important to establish the basis on any property that you purchase. Frequently we see that real estate investors just use the original purchase price for their real estate as the initial basis and forget to add in all the other costs of acquisition that increase the basis. Some closing statements for properties have as many as 25 to 50 lines of items that must be carefully analyzed for inclusion in the basis calculations. For a new purchase, the basis for gains and losses would be the purchase price plus acquisition costs. If purchased through a 1031 exchange, your new basis is generally the basis of the relinquished property that you sold, plus any additional value, whether from equity or debt (including non-recourse debt), assumed in the new replacement property purchase.

Note that acquisition of a property by inheritance or gift results in different calculations for the beginning basis.

Increases to basis would be improvements made, additions to the building or grounds, additional capital calls if any that pertain to improvements not operations, and litigation expenses.

Decreases in basis would be from depreciation taken, a return of capital, tax credits, etc. The first step in analyzing a particular real estate situation is to determine your current adjusted basis, or at least what it is as of year-end.

Capital Gain Characterization

The principal IRC section that governs the taxation of the sale of business real estate is Section 1231. The current maximum rate applicable to capital gains is 15%, however, the law that set this rate is set to sunset at the end of 2010 and the rate is scheduled to returned to the 20% that existed before 2001. See also Publication 544. Most depreciation will be recaptured at a tax rate not to exceed 25%.

Foreclosure or Deed-in-Lieu – General Notes

If a real estate owner is not able to make payments due on the loan secured by the property, then the lender may foreclose on the mortgage. The owner(s) may also voluntarily transfer the property to the lender, or short-sell it to someone else just to pay the loan off.

In all cases, when the property is repossessed, abandoned, short-sold, etc. the owner(s) generally report the disposition as if it were a sale. The amount realized on the sale of the property depends upon how the property was financed in the first place.

Debt

If the owners are not personally liable to repay the debt, then it is called "non-recourse debt" and the sales price - or "amount realized" in CPA language – is the full amount of the debt canceled by the transfer of the property, *even if* the value of the property is less than the outstanding debt. This is the situation most TIC owners find themselves in. Others need to consider recourse debt and its relationship to the fair market value of the property. Or if it is a home they need to consider Internal Revenue Code section 108(a)(1)(E).

Creation of Phantom Income

Phantom income is created when the deemed sale price is greater than the adjusted basis of the property at the time of transfer. Even if there is an economic loss a property owner can be left with substantial phantom income for which real taxes are due at both a federal and state level. Phantom income and the resulting taxes can be expressed in mathematical equations, such as:

Deemed net sales price of the property - Adjusted basis of the property = Phantom Income

Taxes on Phantom Income equal the sum of the following calculations in the order stated:

1) Accelerated Depreciation Portion of Gain x Applicable Ordinary Income Tax Rate (generally between 25-35% at the federal level)
2) Regular Depreciation Portion of the Gain x Applicable Depreciation Recapture Rate (generally 25% at the federal level)
3) Appreciation Portion of the Gain x Applicable Long-Term Capital Gains Rate (usually 15%)
4) Ripple Effect = amount of gain times 0% to 1% for the amount of additional taxes due because you have exceeded the amount of money that can be earned and still be eligible for things such as exemptions, dependents, itemized deductions, etc. before they phase out.
5) State taxes on the above as applicable

How to Start

Start with the attached calculation sheet and work with your tax advisors and real estate agents. If they can't adequately help you then we can calculate your adjusted cost basis for each property that you have owned and exchanged to buy the current one. The important thing is to analyze it correctly so you know what decisions and actions are appropriate. Even if you do the calculations yourself you may want to consult with someone regarding the meaning of it all and the options available to you.

Sincerely,

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CIRCULAR 230 DISCLOSURE

Circular 230 sets forth the rules to practice before the Treasury Department. CPAs are judged to be practicing before the IRS when they give written advice, especially when it represents a substantial claim on a TIC owner's tax return. In the main these tax practice laws were set up to control tax advisors recommending tax shelters felt to be abusive and not in compliance with the law.

This handout is not a covered opinion because it does not address all the significant Federal tax issues and doesn't take into account your individual circumstances. It is not a limited scope opinion either. Under Circular 230 this would be called "other written advice".

As such, Circular 230 requires us to disclose to you that this handout does not afford you protection or exemption from taxes, interest, or penalties on the items discussed here. It cannot be relied on for the purpose of avoiding taxes, interest, or penalties if the IRS feels otherwise.
Circular 230 also prohibits other written advice from being used as a marketing paper to get you involved with another property. The handout has been copyrighted and is controlled and released by us to individuals as a PDF file.

The purpose of the paper is to give some understanding of the various tax laws governing the forced sale of your property and what might ensue with respect to phantom income. It is meant to give a head start to your tax advisors but is just a small piece of the whitepaper on the subject that is designed so your tax advisors don't have to plow through the same code sections, treasury regulations, case law and other commentary to reach the same point and be able to advise you according to your individual facts and circumstances. It is important to consult on this matter with them. They may be able to advise you of suspended passive losses and other tax items that you can match against any taxable gain to mitigate the circumstances.

We would encourage you to involve your tax advisors in this process and we would be happy to confer with them at our standard hourly rates. This is not a matter that we would feel comfortable having Turbo Tax, Tax Cut, H&R Block or other low cost solutions handle.

INFORMATION FOR THE CALCULATION OF ADJUSTED COST BASIS, NET SELLING PRICE, & PHANTOM INCOME

Original Investment Basis

If this was a new non-1031 purchase, what was your gross purchase price?
If this was an exchange, what was the basis of the property acquired as recorded on IRS Form 8824 Like-Kind Exchange?

A. $

Intervening Year Adjustments

What improvements if any, have been made that should be capitalized into the property? (Include capital calls for improvements not operations and repairs to the property that are not capitalizable.)

B. $

What Depreciation have you taken since the purchase?

C. $

ADJUSTED COST BASIS = A+B-C

$

Deemed Sales Price including a Foreclosure or Deed in Lieu of Foreclosure

What is the estimated gross sales price for your property? If not a sale, what Is the amount of debt being taken over upon transfer of the property?

D. $

What selling costs do you predict?

E. $

$

NET SELLING PRICE = D-E

Debt

If your debt was non-recourse only and the property was transferred via foreclosure or deed in lieu of foreclosure then this section is not necessary. Jump directly to the Phantom income calculation below. If any portion of your debt was recourse (meaning you are liable for it, and it wasn't debt on the property only) then please fill out this information.

What is the outstanding balance on the loan now?

F. $

What is the estimated fair market value of the property?

G. $

PHANTOM INCOME CALCULATION

Estimated net selling price less adjusted cost basis = phantom income or (loss)

H. $