



# CHAPTER 14

## Federal Income Tax Laws

## Homeowner deductions

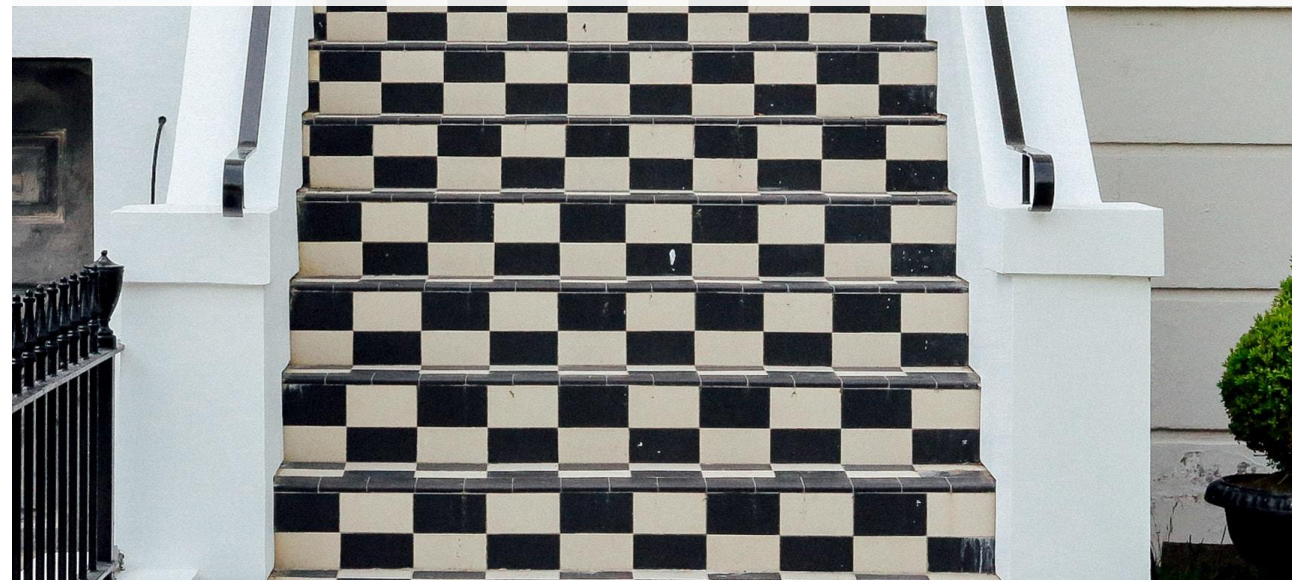
- Mortgage interest
- Real estate taxes

## Taxpayers may deduct acquisition indebtedness

- May deduct interest on \$750,000 of debt for a principal or secondary residence
  - Buy
  - Build
  - Improve



# Federal Income Tax and Personal Residences





# **Federal Income Tax and Personal Residences**

## **Home equity indebtedness**

- Previously homeowners could deduct interest on a home equity loan of up to \$100,000
- Eliminated by the Tax Cut and Jobs Act (TCJA) effective Jan 1, 2018



# Federal Income Tax and Personal Residences

## Capital gain on sale of personal residence

- Principal residence for 2 of the previous 5 years
- \$250,000 exclusion – single taxpayer
- \$250,000 exclusion – married taxpayer filing individual return
- \$500,000 exclusion – married taxpayers filing joint return

## Qualified property

- House, condo, cooperative, mobile home, house trailer, boat
- Must have sleeping, cooking & toilet facilities

# Federal Income Tax and Personal Residences

## Adjusted basis of personal residence for capital gains exclusion (married filing jointly)

### Step 1

|                       |                  |
|-----------------------|------------------|
| Purchase Price        | \$300,000        |
| + Closing Costs       | + 20,000         |
| + Improvements        | + 60,000         |
| <u>Adjusted Basis</u> | <u>\$380,000</u> |

### Step 2

|                        |                  |
|------------------------|------------------|
| Sales Price            | \$780,000        |
| - Closing Costs        | - 45,000         |
| <u>Amount Realized</u> | <u>\$735,000</u> |

### Step 3

|                      |                   |
|----------------------|-------------------|
| Amount Realized      | \$735,000         |
| - Adjusted Basis     | - 380,000         |
| <u>Realized Gain</u> | <u>\$355,000*</u> |

\*Capital gain of \$355,000 is excluded from taxation

A hand holding a magnifying glass over a building under construction. The magnifying glass is held by a hand on the left side of the frame, and the lens is focused on a building with a series of vertical columns. The background is a clear blue sky.

# **Federal Income Tax and Personal Residences**

Losses and repairs are not tax deductible

Early withdrawal penalty from IRA waived if:

- Up to \$10,000 in withdrawn for a down payment
- Up to \$20,000 for married taxpayers

First time homebuyer defined by the IRS

- Have not owned a principal residence for the previous 2 years

## Rental income from a residential unit used as investment property:

- Not used by owners can deduct
  - Interest
  - Taxes
  - Casualty losses
  - Maintenance
  - Utilities
  - Insurance
  - Depreciation



# Vacation Homes and Home Office

# Vacation Homes and Home Office

May not deduct expenses exclusively  
as investment property:

- Personal use more than 14 days or more than 10% of days rented
- Rent the unit for less than 15 days

**Use for both rental and personal use:**

- Can divide expenses between rental and personal use





# Federal Income Tax and Investment Property

Potential **G**ross **I**ncome  
- **V**acancy & **C**ollections  

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Effective **G**ross **I**ncome  
- **O**perating **E**xpenses  

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Net **O**perating **I**ncome  
- **A**nnual **D**ebt **S**ervice  

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Before **T**ax **C**ash **F**low  
- **I**ncome **T**axes  

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After **T**ax **C**ash **F**low



# Real Estate Investment Terminology

Income tax formula:

## Step 1

|       |                      |
|-------|----------------------|
| NOI   | Net Operating Income |
| + RES | + Reserves           |
| - TD  | - Tax Depreciation   |
| - MI  | - Mortgage Interest  |
| <hr/> | <hr/>                |
| TI    | Taxable Income       |

## Step 2

|       |                     |
|-------|---------------------|
| TI    | Taxable Income      |
| x TR  | x Investor Tax Rate |
| <hr/> | <hr/>               |
| IT    | Income Tax          |

\*Note: If taxable income is negative a tax shelter has been created

# Federal Income Tax and Investment Property

**Calculate:**

**Before Tax Cash Flow**

Potential **Gross Income**

- Vacancy & Collections

**Effective Gross Income**

- Operating Expenses

**Net Operating Income**

- Annual Debt Service

**Before Tax Cash Flow**





# Federal Income Tax and Investment Property

**Calculate:**  
**After Tax Cash Flow**

- Potential **G**ross Income
- **V**acancy & **C**ollections

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- Effective **G**ross Income
- **O**perating **E**xpenses

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- Net **O**perating Income
- **A**nnual **D**ebt **S**ervice

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- Before Tax Cash Flow**
- **I**ncome **T**axes

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- After Tax Cash Flow**

# Income Producing Real Estate

- Depreciation (cost recovery)
- Modified Accelerated Cost Recovery System (MACRS)

Residential Income  
Producing Buildings

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**27.5 Years**

Non-Residential Income  
Producing Buildings

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**39 Years**



# Income Producing Real Estate

## Depreciation (cost recovery)

- Example: 500 unit Apartment property purchased for \$800,000

|                           |                 |
|---------------------------|-----------------|
| Purchase Price            | \$800,000       |
| Commission                | + 20,000        |
| Survey Costs              | + 5,000         |
| Engineering Due Diligence | + <u>50,000</u> |
| Total Acquisition Cost    | \$875,000       |

Land Value = 20%

$80\% \times 875,000 \div 27.5 = \$25,454$  annual depreciation  
(straight-line depreciation)

- Granted by State Housing Authority
- Investors receive federal tax credits for 10 years
- Applies to low-income residential rental buildings
- Tax credit = \$ for \$ tax reduction
  - \$10,000 tax credit = \$10,000 reduction in taxes due



# Tax Incentives for Low-Income Housing



# Taxes From Operations

## Active income

- Earned

## Portfolio income

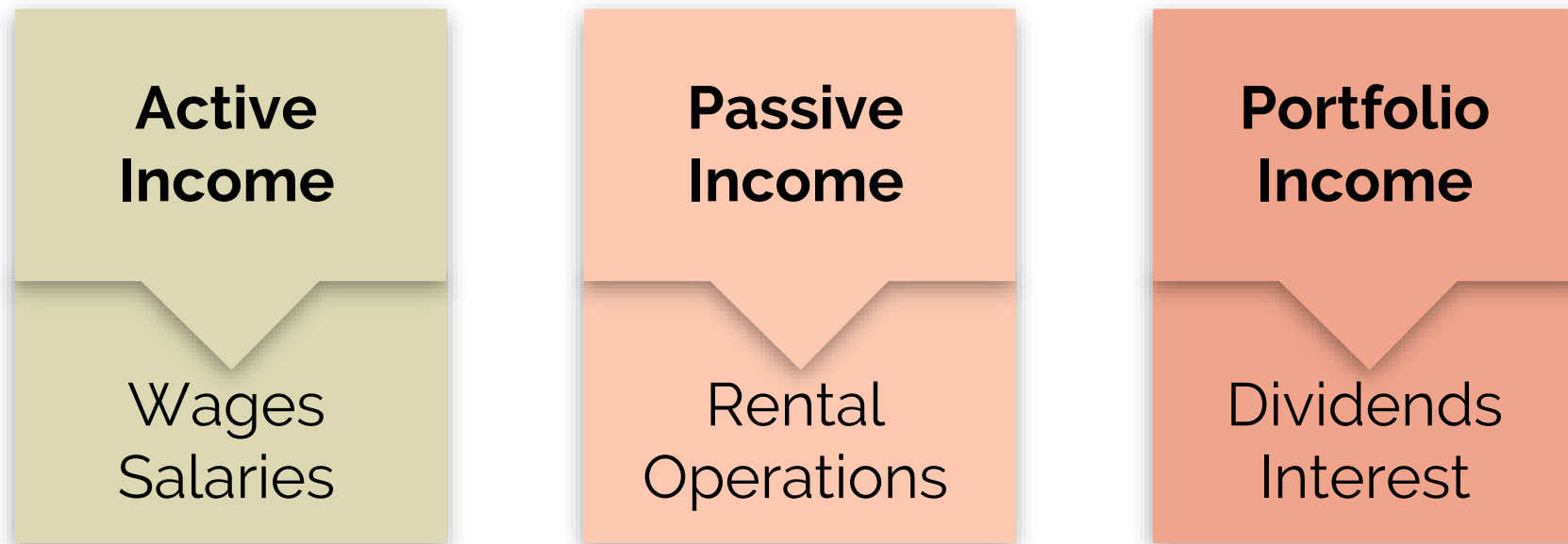
- Stocks and other similar investments

## Passive income

- Real estate, rent, etc.



# Taxes From Operations



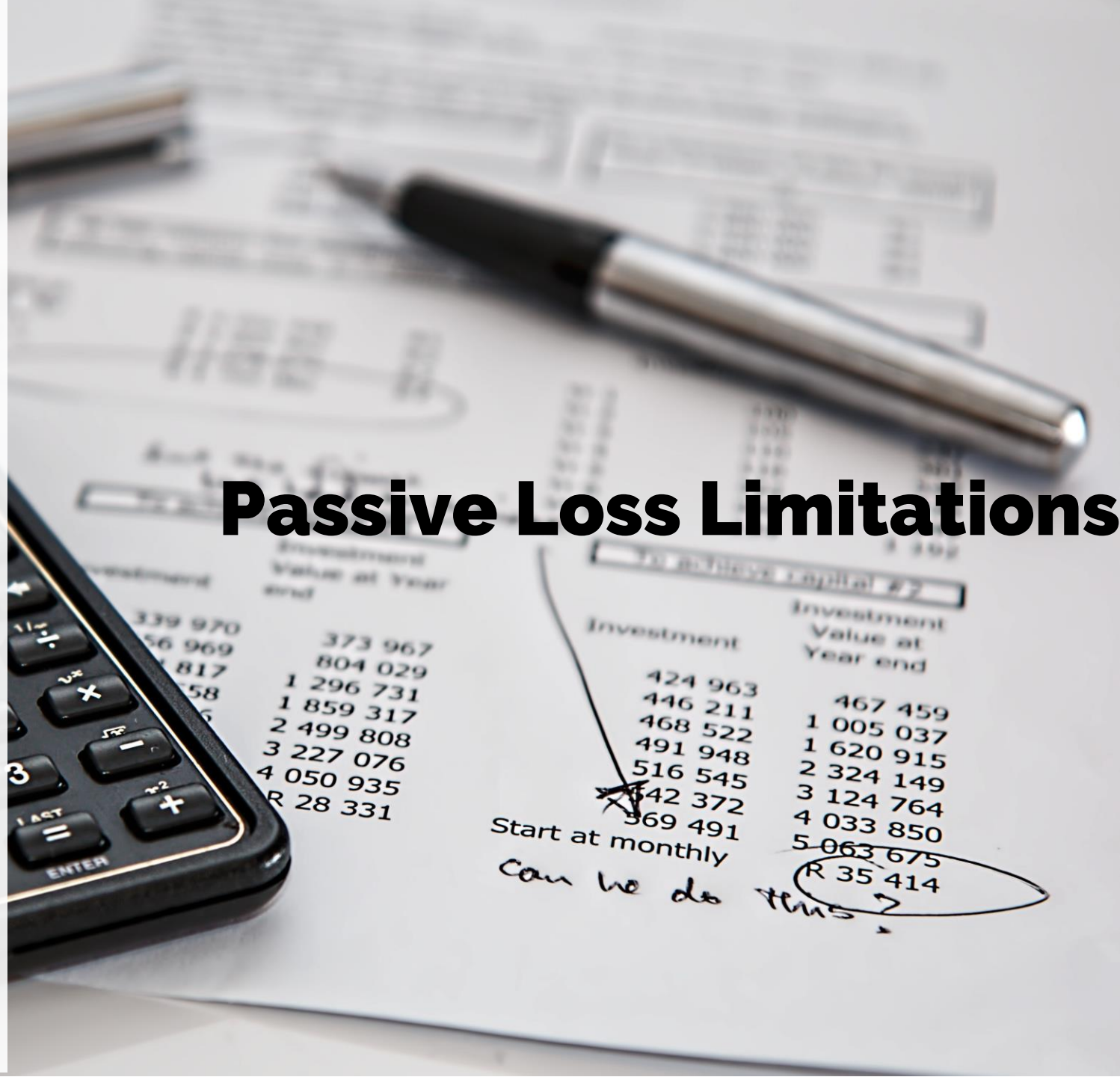
Losses can only be applied to the category where they occurred. (unable to sustain losses in passive income and deduct from active income)

## **\$25,000 Exception for Active Participants**

Passive losses can be deducted from active income  
Taxpayer makes management decisions  
Offset \$25,000 per year in losses from real estate operations

## **Real Estate Professional Exception (material participants)**

Can deduct passive losses against active income without limitation  
At least 750 hours and 50% personal services to the real estate industry





## **Tax Shelter**

- Property appreciates
- Has negative taxable income
- Positive cash throwoff (BTCF)

# Capital Gains & Losses



## Capital asset

- Not held for sale in the normal course of business

## • 2 Methods Tax Deferrals

### Installment Sale (tax deferral)

- Seller financing
- Defers capital tax gain until cash is received
- Pay taxes on amounts received each year
- Avoids paying large capital gain tax in year of sale

## 2 Methods Tax Deferrals

### 1031 Tax Exchange

- Exchange of qualifying of like-kind property
- Investment property for investment property
  - Apartment building for a golf course
- Not for personal residence

### Boot

- Cash exchanged in addition to property
- Party receiving cash must pay taxes on amount received

## Like-Kind Exchange





# Like-Kind Exchange

## Timing of 1031 Tax Exchange

- Sell or purchase property before exchange property is found
- 45 days to identify replacement property
- Sale of replacement property must close within 180 days
- U.S. Property only

## Exclusion of gain on sale of personal residence

- \$500,000 capital gain exclusion for married couples filing a joint tax return
- \$250,000 for married couples filing individual tax returns
- \$250,000 for single persons filing tax return
- Can use every 2 years (must live in residence for 2 of the previous 5 years)



**Taxpayer Relief Act**

# Taxpayer Relief Act



## Partial Exclusion of gain on sale of personal residence

- Personal residence is sold before 2 years
- Classified as unforeseen circumstance
  - Employment change over 50 miles
  - Health
  - Death
  - Divorce
  - Unemployment



# Capital Gain Tax Rates

Taxpayer Relief Act of 2012 (Income Property)

| <b>Single Taxpayer</b> | <b>Married Filing Jointly</b> | <b>Capital Gain Tax Rate</b> |
|------------------------|-------------------------------|------------------------------|
| \$0 - \$35,250         | \$0 - 72,500                  | 0%                           |
| \$35,251 - \$400,000   | \$72,501 - 450,000            | 15%                          |
| \$400,000+             | \$450,000+                    | 20%                          |



# Coffee Break

15 Minutes