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Paying attention to land/building allocation can save you taxes

September 19, 2013 - Construction Design & Engineering

Investors who are selling real estate often forget to consider an important question: How is the sale price of the property split between the land and the building? The answer can make a big difference when it comes time to pay the tax bill.

Frequently, the allocation of the sale price between the land and building is an afterthought. The land and building allocation is generally carefully considered when the property is purchased. Buyers typically want more of the purchase price allocated to the building so that they can depreciate it and have current ordinary deductions. Land, on the other hand, is non-depreciable and does not yield any current ordinary deductions. This entices the buyer to allocate more purchase price to the building.

But what happens when the building is sold? Taking the time and effort to determine the sale price allocation between the land and building can be fruitful. The reason for this is the spread in tax rates between unrecaptured 1250 gain of 25% and regular capital gain rates of 20%. Unrecaptured 1250 gain is the recharacterization of the gain after depreciation that has been taken on the building.

As an example, assume an investor that bought a building for $10 million and allocated $8 million to the building and $2 million to the land at the time of purchase. During the time the investor owns the property, $2 million of tenant improvements are performed on the property. Having depreciated the building and improvements by $4 million, the investor is now selling the property for $12 million resulting in a $4 million gain. If a sale price allocation between and land building is not determined, potentially the entire $4 million gain would be taxed at the unrecaptured 1250 gain rate of 25%.

However, by using an appropriate sale price allocation, the results can be very different. Assuming the fair market value split between the land and building is 25%/75% respectively, it would result in the value of the land being $3 million and the building being $9 million. There is still a $4 million gain on the sale. But now only $3 million is taxable as unrecaptured 1250 gain. The restâ€"the portion attributable to the landâ€"is considered regular capital gains, which are now taxed at a maximum rate of 20%. The result is a tax savings of $50,000.

Determining the Values

The seller needs to be able to substantiate the fair market value split between the land and building when allocating the sale price. The fair market value should be the price a third party would be willing to pay in an arm's length transaction. Appraisals are the best support for the sale price allocation but other documentation is acceptable is it takes into effect all of the facts and circumstances of the transactions.

Additionally, the buyer and seller don't have to agree on the sale price allocation at the time of the sale. In a perfect world, the allocation would match. However, there is no mechanism by which the two parties need to agree on an allocation. Each party may have different plans for the property which could make the allocation differ.

Moreover, the split between land and building can change dramatically during the time that an investor owns the property. Consider the case of an owner who purchased a property with an original allocation to the building of 80% and to the land of 20%. During the time the investor owns the building no improvements are made and minimal upkeep is performed. When the investor went to sell the building 15 years later, an appraisal placed the fair market allocation between building and land at 55% building and 45% land due to the condition of the building and the location. As a result, the investor was able to save a significant amount in taxes.

Ideal Situations

There are a number of ideal situations to investigate the allocation of the sale price on a sale. Some of these are as follows:

* Properties where the building is close to or fully depreciated.
* Properties that require extensive renovations in valuable locations.

Additionally, such allocations can work well in places such as Boston, New York and San Francisco, where the land is valuable and location is critical. In such cases, it is easier to argue that the value of the property is primarily in the land, not the building.

While sellers should always re-evaluate the allocation of value between land and building, there isn't always a savings. Sometimes, the depreciation of the building is too high or the value of the land too low, that such calculations make no difference.

However, those not investigating an allocation of the sale price could be missing an important opportunity to trim their tax bill.

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