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New rules may lead to new tax savings in a sale

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When investors sell real estate, they often focus on the overall cash received with little focus on the potential tax savings. They can overlook strategies that may reduce their tax liability. These strategies include the allocation of the sales proceeds between land and building and new developments that can provide a one-time opportunity to save when selling real estate.

Allocation of Land and Building

Frequently, the allocation of the sales price between the land and building is an afterthought. However, there can be some great tax savings if some time and effort is spent to allocate the price between the land and building. The tax savings occurs due to a spread in tax rates between unrecaptured 1250 gain of 25% and regular capital gain rates of 20%. The unrecaptured 1250 gain is the amount of gain related to the depreciation taken on the building. Essentially, the IRS is giving you an ordinary deduction when you take the depreciation expense so they want you to pay a 25% rate on the portion of the gain that related to that depreciation expense. Any gain above and beyond the past depreciation taken will be taxed at 20%.

For example, an investor buys a building for $10 million and allocates $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. The $4 million gain remains on the sale but now only $3 million is taxable as unrecaptured 1250 gain. The rest—the portion attributable to the land—is considered regular capital gains, which are now taxed at a maximum rate of 20%. The result is a tax savings of $50,000.

New Developments

New regulations have been released by The Treasury Department that can create an opportunity to save even more. Under these new rules, effective in 2014, taxpayers can now realize an ordinary loss on building assets it has disposed of. If the plan was to sell the building, this may allow for an ordinary loss on the replacement of certain assets while increasing the taxable capital gain. The spread on tax rates can result in up to a 20% rate difference. Additionally, the removal of disposed of assets also removes the prior depreciation taken resulting in a lower unrecaptured 1250 gain that was discussed above.

Assuming the same facts as the example above accept that the investor replaced the elevators for $800,000. If the taxpayer works with their advisor and determines that the original elevators were

$600,000 of the original $8 million purchase price, they could realize an immediate ordinary deduction of $360,000 by writing off the adjusted basis of the old elevators. This would increase the taxable gain by $360,000 and potentially reduce the unrecaptured 1250 gain by $240,000. The tax savings in this case is $72,000.

While tax savings are not always apparent in a sale, investigating options with a knowledgeable advisor can uncover strategies to trim the tax bill when selling a property.

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