Section 18 – Part 2

SLIDE 11 - **Federal Income Taxes (Cover Page)**

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Basic Taxation Concepts

Federal income tax is a progressive tax, meaning that the more a taxpayer earns in a year, the higher his tax rate will be

Income is any economic benefit realized by a taxpayer (unless specifically excluded)

A deduction is subtracted from a taxpayer's income before tax owed is calculated; a credit is subtracted directly from the amount of tax owed

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Gains from the sale or exchange of an asset are treated as income, but in some cases losses may be deducted from income; losses on the sale of a principal residence may not be deducted

A taxpayer's basis in a property is her investment in it; adjusted basis is the acquisition cost plus capital expenditures (minus, for some properties, depreciation deductions)

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A gain is not taxable income until it is realized, when a sale or exchange occurs; the gain or loss is the amount realized minus the adjusted basis

A gain is recognized in the year it is taxed (usually the year it is realized, unless it is a tax-deferred transaction or taxes are excluded)

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Basic Taxation Concepts
Capital Gains and Losses

If property is sold for a loss, the loss is usually not deductible.

The only losses an individual may deduct are those connected with:

- the taxpayer's trade or business
- a transaction entered into for profit
- theft or casualty loss of the taxpayer's property.

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Capital gain or loss: A gain or loss that results from the sale of a capital asset.

- Capital asset is property held for:
  - personal use, or
  - investment purposes
- Capital gains are taxed at a lower rate than ordinary income.
- Capital losses also receive special tax treatment.

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Even though a loss on a home or other property held for personal use is a capital loss, it isn't deductible.

Capital losses on property held for investment purposes are deductible.

Deductible capital losses are subtracted from capital gains, resulting in a net gain or loss.

Net loss may be deducted.

But no more than $3,000 in net capital losses may be deducted in a single year.

Net losses in excess of limit may be carried forward and deducted in future years.

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Basic Taxation Concepts
Basis

IRS will use adjusted basis to calculate capital gain or loss when the property is sold.

To calculate adjusted basis:

- start with initial basis
- add capital expenditures
- subtract allowable depreciation deductions

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Capital expenditures: Expenditures that add to a property's value or extend its life.

Examples: remodeling; new roof

Maintenance expenses are not capital expenditures.

Examples: painting; fixing leaky plumbing

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Principal Residence
Tax Advantages

Federal government's policy is to promote home ownership.

- Mortgage interest deduction on the principal home and second home
- Deduction of property taxes on principal residence and second home
- IRA withdrawal for <u>first time home buyers</u> without penalty,
- Exclusion from gain from sale of principal residence, so long as the gain does not exceed $250,000 for a single person or $500,000 for a couple filing jointly.

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Principal Residence
IRA Withdrawals

Generally, early withdrawal from individual retirement account (IRA) is taxable income and subject to additional 10% tax penalty. But homebuyer can withdraw funds from IRA without penalty.

Traditional IRA

- Person buying, building, or rebuilding first home can withdraw up to $10,000 in IRA funds without penalty (married couple can withdraw up to $20,000).
  - First-time buyer: cannot have owned principal residence during previous two years

Roth IRA

- Same exception as for traditional IRAs, but buyer must have held account for at least 5 years

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Investment Real Estate

Types of income and cash flows

- **Potential gross income**: Income based on 100 percent occupancy.
- **Effective gross income** (EGI): Gross income less a factor for vacancy and collection loss.
- **Net operating income**: Gross income less expenses (depreciation, principal and interest payments i.e. mortgage debt are not deducted).
- **Before Tax Cash Flow** (Cash Throw-Off): The amount of cash flowing through the business before taxes (income or property) are paid.
- **After Tax Cash Flow**: The amount of money the investor can keep or reinvest after taxes are paid

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Determining Taxable Income

Taxable Income is the net income, after allowable deductions and adjustments, on which the tax rate is applied

The following are taken into consideration:

- Reserves for replacement: Funds set aside to replace a short-lived component of a property.
- Interest
- Depreciation

Additionally, capital gains (or losses) for both the short and long term are taken into account for tax purposes.

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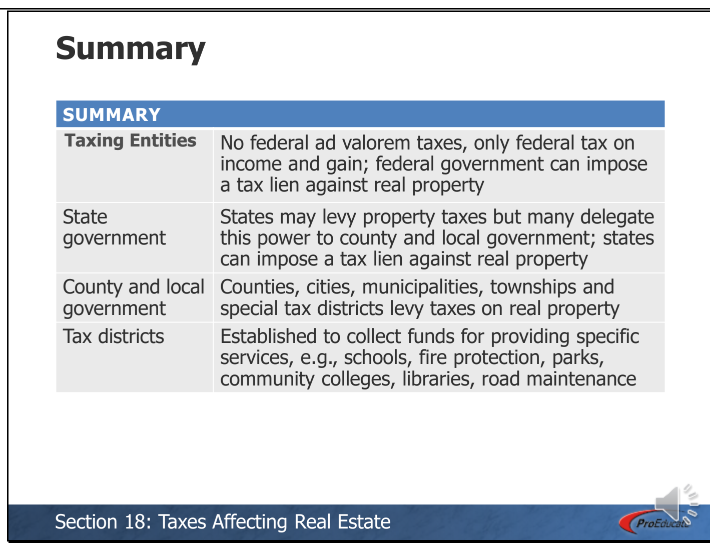
Installment Sale

A method of reporting income received from the sale of real estate when the sales price is paid over time. If the sale meets certain requirements, a taxpayer can postpone reporting such income to future years and therefore lessen the tax burden. This may also be called a contract for deed.

Like kind exchange is a reciprocal transfer of real property which has certain tax advantages over a sale. Definite procedures must be followed in order to qualify the transfer as an exchange.

Slide 1



Slide 2

Summary

SUMMARY	
Ad Valorem Taxation	
	Property tax levied annually on the taxable value of a property in order to help fund government and public services
Tax base totaling	Tax base equals the total of assessed values of all real property within the area, excluding exemptions
Homestead exemption	A tax exemption of a portion of the assessed value of a property owned and occupied as a family home
Other exemptions	immune from tax: government-owned properties; exempt from taxes: properties owned by non-profit-organizations

Section 18: Taxes Affecting Real Estate

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Summary

SUMMARY	
Tax rate derivation	(1) Taxing entity determines what budget requirements must be met by ad valorem tax; (2) Divide tax requirement by the tax base Tax rate stated as mills ($.001), or dollars per $100 of assessed value, or dollars per $1,000 of assessed value, or as a percentage of assessed value
Tax billing and collection	Individual tax bill: tax rate times taxable value

Section 18: Taxes Affecting Real Estate

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Summary

SUMMARY	
Special Assessments	
	Tax levied against specific properties that will benefit from a public improvement; amount is based on a pro rata share of the cost of the improvement and the value each parcel will receive from the improvement

Section 18: Taxes Affecting Real Estate

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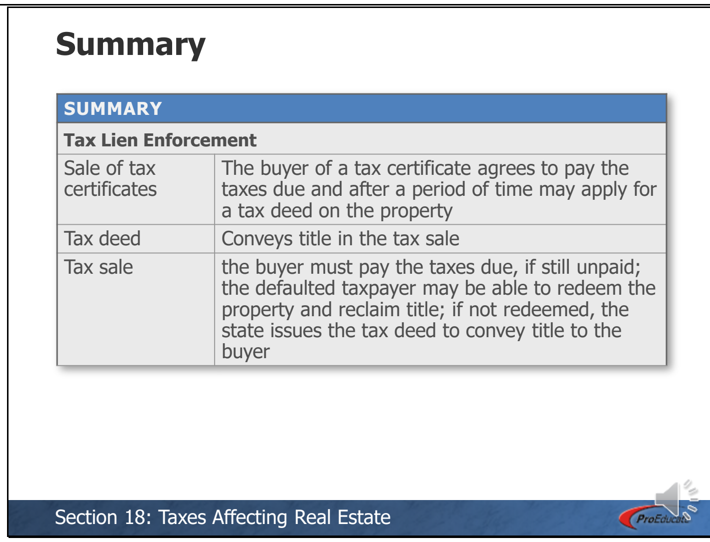
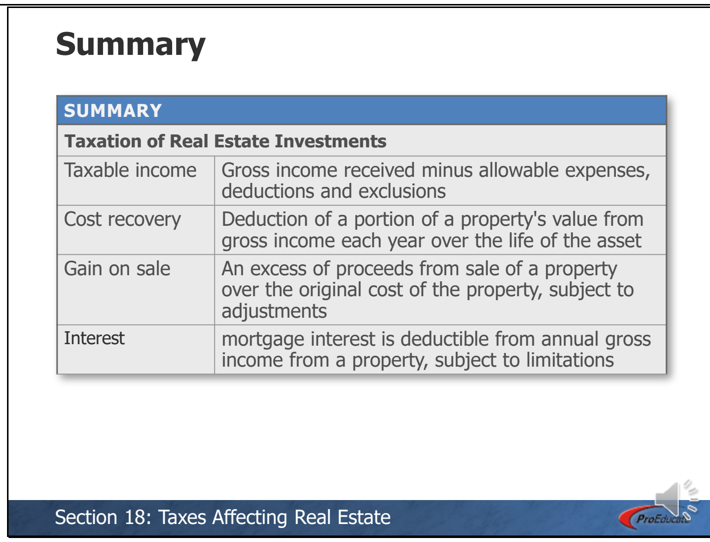
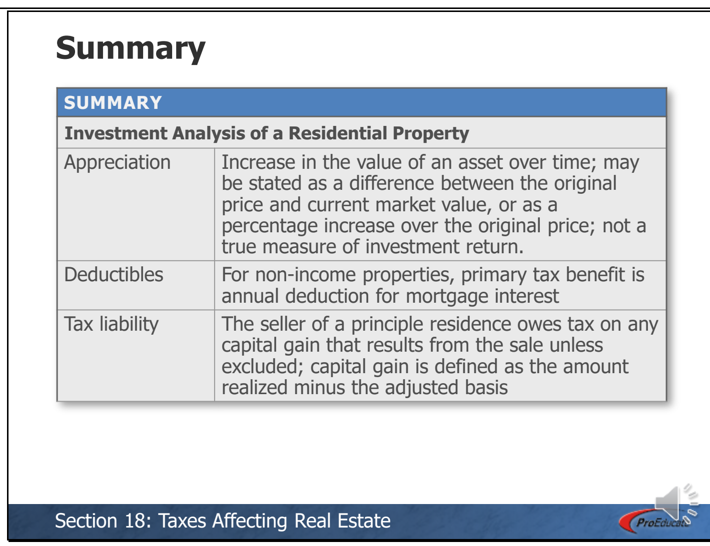
Slide 5		
Slide 6		
Slide 7		

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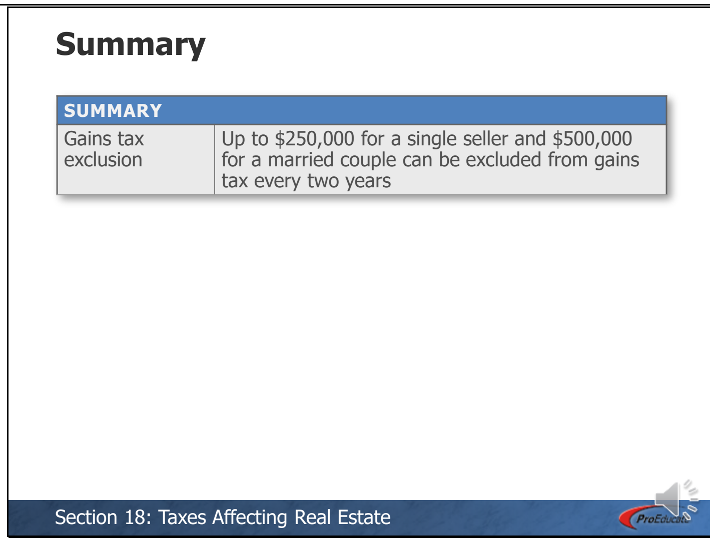

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