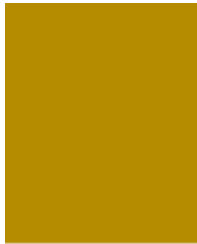


**MICHAEL BEST**

& FRIEDRICH LLP



# **National Association of Industrial and Office Properties**

## **A Six Pack for Breakfast**

### **Capital Gains and Sales of Depreciated Real Estate**

**Bret A. Roge**

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## Overview

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- Basic Concepts.
- Depreciation Recapture.
- Example.
- Pending Legislation Affecting Tax Treatment of Capital Gains.

## Basic Concepts

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Capital gains and capital losses are gains and losses from the sale or exchange of capital assets.

## **Tax Treatment of Capital Gains**

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For noncorporate taxpayers, the tax rate applied to capital gains generally is 15%, though it can range from 0% (for low-income taxpayers) to 25% (for unrecaptured depreciation on real property). The capital gains tax rate typically is much lower than the tax rate applied to ordinary income, which can reach 35% (or nearly 38% if the noncorporate taxpayer is subject to the 2.9% Medicare tax for the self-employed).

For C-corporations, the ordinary income tax rate applies to capital gains and cannot exceed 38% (the highest marginal rate applicable to C-corporations).

## Tax Treatment of Capital Losses

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For noncorporate taxpayers, capital losses may be used to offset capital gains and, once capital gains are fully offset, may be used to offset up to \$3,000 of ordinary income (under a pending Senate Bill, this limit may be increased to \$10,000.) Noncorporate taxpayers may carry forward capital losses for an unlimited number of years.

For C-corporations, capital losses may only be used to offset capital gains. Generally, C-corporations may carry back capital losses three years and may carry those capital losses not absorbed by the carryback forward five years.

Because capital losses are limited to offsetting capital gains and a small amount of ordinary income, they are not as tax advantageous as ordinary losses, which potentially can be used to offset an unlimited amount of ordinary income.

### What is a capital asset?

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A capital asset is “any property” held by a taxpayer with several very important exceptions relevant to real estate developers. The following exceptions are NOT capital assets:

- Depreciable property and real property used in a trade or business (though such property may receive favorable tax treatment under Section 1231 of the Internal Revenue Code, described on the next slide).
- Property which would properly be included in inventory if on hand at the close of the taxable year and property held primarily for sale to customers in the ordinary course of the trade or business, such as lots held by a developer and condominiums held for sale.
- Accounts and notes receivable acquired in the ordinary course of trade or business from the sale of property held primarily for sale to customers.

## Section 1231: Combining the Tax Advantages of Capital Gains and Ordinary Losses

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- Section 1231 of the Internal Revenue Code contains a special rule for “Section 1231 Property,” which includes real property held for more than one year and used in a trade or business.
- Section 1231 Property does NOT include property of a kind that would be included in inventory if on hand at the close of the taxable year and property held primarily for sale to customers in the ordinary course of the trade or business (e.g. lots and condominiums).
- **Generally, noncorporate taxpayers pay capital gains tax rates on gains recognized from the sale or exchange of Section 1231 Property, while losses from the sale or exchange of such property are treated as ordinary losses.**

Thus, Section 1231 permits taxpayers to take advantage of lower capital gains rates and favorable ordinary loss rules.

But...

## Depreciation Recapture

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Gain that would otherwise be characterized as capital gain may be subject to higher tax rates if it is subject to “depreciation recapture.”

Many types of depreciable property are subject to depreciation recapture, including depreciable real estate.

### Section 1250 Property

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A 25% tax rate applies to the portion of the gain attributable to “unrecaptured depreciation” – that is, past depreciation – for “Section 1250 Property,” which includes many types of depreciable real estate.

Ordinary tax rates apply to the portion of certain gains on Section 1250 Property to the extent that unrecaptured depreciation exceeds straight-line depreciation.\*

\*Depreciation on Section 1250 Property rarely is subject to recapture at ordinary income rates because most Section 1250 Property is depreciated on straight line basis. Certain types of Section 1250 Property, such as qualified leasehold improvements, may be subject to recapture at ordinary income rates.

## **Section 1245 Property**

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Ordinary tax rates apply to the portion of the gain attributable to “unrecaptured depreciation” for “Section 1245 Property,” which generally includes tangible personal property, such as furniture or equipment.

## Example

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### Assumptions:

- Property purchased in 2006 for \$3,500,000.
- \$2,000,000 of the property is Section 1250 Property depreciated over 39 years.
- \$1,000,000 of the property is Section 1245 Property depreciated over 7 years.
- \$500,000 of the property is non-depreciable land.
- In 2009, 3 years after purchasing the property, the taxpayer sells it for \$4,000,000.

## Adjusted Basis

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■ Starting basis	\$3,500,000
■ Less depreciation	<u>(\$800,000)</u> estimated
■ Ending basis	<u><u>\$2,700,000</u></u>

## Calculation of Gain

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■ Sale Price	\$4,000,000
■ Less Adjusted Basis	<u>(\$2,700,000)</u>
■ Gain	<u><u>\$1,300,000</u></u>

## Categorizing the Gain of \$1,300,000

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Gain Subject to Ordinary Income Tax     \$640,000  
(Section 1245 depreciation recapture)

Gain Subject to 25% Capital Gains Tax     \$160,000  
(Section 1250 depreciation recapture)

Gain Subject to 15% Capital Gains Tax     \$500,000  
(Remaining Gain)

## Calculating the Tax

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Ordinary Gain (35% tax bracket)	\$224,000
25% Capital Gain	\$ 40,000
15% Capital Gain	<u>\$ 75,000</u>
Total Tax on Gain	<u>\$339,000</u>
Effective Tax Rate on Gain	26%

(Note, the foregoing example ignores state income taxes.)

## Pending Legislation Affecting Tax Treatment of Capital Gains

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### FEDERAL

President Obama has issued his proposed fiscal year 2010 budget which, among other things not relevant hereto, would:

- a. Increase the capital gains tax rate to 20% for taxpayers with income over \$250,000 (\$200,000 if filing singly) effective for tax years beginning after December 31, 2010.
- b. Tax “carried interest” at ordinary income tax rates rather than capital gains tax rates (see next slides) for tax years beginning after December 31, 2010.

## Taxation of Carried Interest – Current Law

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Carried interest is a profits interest given to a general partner of a partnership or manager of a limited liability company (“LLC”) for little or no capital contribution. For example, a manager of an LLC has a 1% membership interest, but is entitled to 20% of the gains or profits of the LLC after the non-manager members have been returned their capital contributions.

Under current law, the carried interest is taxed at capital gains tax rate if the investments of the partnership or LLC are held for at least one year (rather than as compensation for services, which is taxed at ordinary income tax rates).

### Taxation of Carried Interest – Pending Legislation

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On April 3, 2009, Congressman Sandy Levin introduced a bill, currently in the House Committee of Ways and Means, that would tax carried interest at ordinary income tax rates for individuals performing investment adviser or similar services to partnerships.

The legislation would apply to an “investment services partnership interest,” defined as any interest in a partnership which is held by any person if it was reasonably expected at the time such person acquired such interest that such person would provide a substantial quantity of any of the following services:

- a. Advising as to the advisability of investing in, purchasing, or selling any specified asset;
- b. Managing, acquiring, or disposing of any specified asset;
- c. Arranging financing with respect to acquiring specified assets; or
- d. Any activity in support of any service described in (a) through (c).

The term “specified asset” includes real estate held for rental or investment.

## Taxation of Carried Interest

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An exception from ordinary income treatment would exist for “qualified capital interest,” which is the portion of a partner’s interest in the partnership that is attributable to:

- a. the fair market value of any money or property the partner contributed to the partnership in exchange for such interest;
- b. any amounts included in gross income under Section 81 with respect to the transfer of such interest; and
- c. any net income or net loss previously allocated to the interest less any distributions to the partner.

\* Note: The legislation does not contain a proposed effective date.

### Wisconsin

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On May 28, Wisconsin's Joint Committee on Finance approved an omnibus tax motion as part of the budget process that would:

- Increase the tax on capital gains by 50% by decreasing from 60% to 40% the percentage of capital gains that is subtracted from federal adjusted gross income for purposes of calculating income subject to Wisconsin's individual income tax.
- Defer taxation of long-term capital gains that are reinvested in qualified new business ventures.

The budget bill will be taken up by the Assembly next and then the Senate.

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