TAX ISSUES IN SALES

The nature of the sale should govern the deal, not the tax consequences.

If the sale is due to belief that the real estate market & the stock market are at or near the top, then it is a good time to cash out and take your gain.

On July 31, 1997, Congress overwhelmingly passed HR 2014, The Taxpayer Relief Act of 1997.

The legislation provides for a reduction in the tax rate applied to capital gains for individual taxpayers (including partnerships). No reduction is provided for corporations

The effective date of the capital gains provisions is July 29, 1997.

Taxpayers in the 39.6%, 31% and 28% income tax brackets will see their capital gains tax rates reduced from 28% to 20%. The capital tax rates for taxpayers in the 15% income tax bracket was reduced to 10%.

The tax rate on straight-line depreciation deductions "recaptured" upon sale was reduced to 25%.

The holding period for assets eligible for capital gains tax treatment has been increased from 12 months to 18 months. However, certain conditions apply.

Like-Kind Exchange Rules. Fortunately, the legislation makes no changes to the current like-kind exchange (Sec. 1031) rules for investment property.

On the other hand, if you believe that the market is not at or near the top, or you believe that there may lie better tax treatment ahead, you may want to defer your tax gain. The two most popular are: Section 1031 Like Kind Exchanges and Sale to an UpREIT/DownREIT.

Section 1031

Internal Revenue Code Section 1031 allows the tax deferred exchange of investment real estate. [The tax deferred exchange is also known as a "Starker," named after the first tax case on this topic.]

Section 1031 allows the exchange of investment or business property for other investment or business property, without paying tax if the property received is "like kind."

Any rental or investment property in the United States is eligible for Section 1031. A rental condo may be exchanged for a farm; an office building may be traded for an apartment building.

Section 1031 does NOT apply to a personal residence or to a vacation home.

The replacement property must be identified within 45 days and acquired within 180 days of the sale of the old property.

The Seller must not have the right to receive the sales proceeds.

Section 1031 does NOT apply to a Partnership Interest. If a Partnership owns real estate, the Partnership may enter a Section 1031 exchange; individual partners may not trade a share of one Partnership for another, or for real estate.

Since it is very rare that 2 people will have properties desired by the other, a fiction has been devised to twist reality to fit the Tax Code.

An accommodator is hired to facilitate the trade; Tom signs papers approved by his lawyer to transfer First Street to accommodator; accommodator signs the property over to Sam; commissions are paid; net proceeds are held by accommodator.

Tom then finds a new property. He makes an offer (after his lawyer reviews it) which includes "Seller will co-operate in a Section 1031 exchange, at no cost to Seller.

The accommodator buys the new property for Tom with the net proceeds from First Street.

The difficulty of Section 1031 is that the Seller cannot have "actual or constructive receipt" of the funds before receipt of the replacement property. If the Seller has control over the funds he has constructive receipt and tax deferral is voided.

In the past it was feared that if Seller were to receive interest earned during the escrow period, the IRS would claim constructive receipt voiding tax deferral. New IRS Regulations clarified that interest may be received by the Seller without causing constructive receipt.

The replacement property must be "identified" within 45 days of the sale of the old property, and acquired within 180 days [and before the (extended) due date of the taxpayer's tax return] from the sale of the old property.

How to identify: A written document signed by the Seller, delivered, mailed, faxed or sent to any other (non-related) person involved in the transaction is sufficient.

Specificity of identification: The street address or legal description of the proposed replacement property.

Alternate identification\ of replacement properties is allowed, IF (1) no more than 3 alternate properties are described (e.g. 1 First Street, 2 Second Street, or 3 Third Street as alternate replacement properties), or (2) up to twice the value of the old property as identified as the target properties (e.g.. any of the following 6 properties, the total value of which is not is not more than 200% of the value of the old property).

Multiple new properties may be purchased.

Ineligible property received in the transaction is "boot". Profit is taxable to the extent of boot.

There are several kinds of boot. First is cash.

The complicated kind of boot is net debt relief.

At present, there is no holding period requirement in the law.

You may trade properties repeatedly and frequently.

REITS: THE OTHER OPTION TO SELL TO A REIT.

A REIT is a creature of tax law. Since 1960, federal tax law has provided special tax treatment to trusts or corporations that invest substantially all of their capital in real estate, whether through outright purchase of real estate or by making loans that are secured by real estate.

A REIT is basically a mutual fund for real estate, the purpose of which is to provide small investors the ability to participate in sophisticated real estate investments.

The real estate industry did not experience much activity from REITs until the late 1980's.

In the mid-1980's, Congress changed tax laws in an effort to curtail the use of limited partnerships as tax shelters.

With limited partnerships no longer a tax beneficial means to invest in real estate, REITs became the subject of new interest from investors in the real estate industry.

Today, REITs have become substantial players in the real estate market. REITs currently invest nearly $140 billion in the real estate market and are growing in number and size.

The law provides REITs limited methods to expand. To grow, a REIT must acquire new investors and use their funds to acquire new real estate investments because under the tax law, nearly all income earned from a REIT's real estate investment must be distributed.

Any discussion of REITs in trade journals generally includes a discussion of the buzzwords "UpREITs" and "DownREITs."

Both terms apply to tax favorable methods by which investors can sell appreciated real estate to REITS.

REITs have created special mechanisms that allow them to offer real estate investors the ability to sell their investments to a REIT without incurring income tax on the investor's gain in these investments.

UPREIT

An UpREIT is a term used for an "umbrella partnership REIT." Taubman Centers, Inc. Is the first publicly traded UPREIT and went public on November 26, 1992.

The REIT acts as the partnership's general partner and real estate investors who wish to sell their properties, "sell" to the partnership by contributing properties in return for limited partnership interests known as units.

Under the tax law, investors can contribute appreciated property to partnerships without reporting the taxable gain. In return for that tax benefit, investors have a tax basis in their partnership interest equal to their tax basis in the property contributed. Units are priced though to equal and continue to be valued by reference to the shares of the REIT.

The key benefit of the UpREIT partnership is that the Contributor also will have the right to convert the partnership interest into either cash or REIT shares.

If the Contributor exercises the right to convert the partnership interest into cash or REIT shares, the Contributor at that time will recognize the gain and pay tax on that gain. There is usually an agreed upon holding period of 1 to 2 years though.

The benefit to the Contributor is that by continuing to hold the interest the Contributor will receive a return not only on the Shopping Complex but other properties held in the UpREIT partnership.

The Contributor is guaranteed liquidity. The Contributor can convert its partnership interest at any time into cash or REIT shares and can also borrow against the partnership interest although this is usually limited to no more than 50% LTV. It also provides cash flow. The Contributor typically receives cash flow distributions equal to dividends per share from the investment in the OP until all shares are redeemed.

SO: (1) The Contributor has diversified effectively its real estate holdings, (2) has obtained liquidity for its investment and has not paid income tax on its appreciation in the Complex.

Additional tax benefits are gained, however.

Advantages

It generally allows some or all of the sponsors to defer or mitigate their tax liability tax on negative basis recapture with respect to the contributed properties.

Property Debt

If the property to be transferred to the OP for units is subject to debt at the time of transfer, whether the taxable gain will be recognized and the amount of that gain will depend upon the application of very technical tax rules. It is possible, however, to state some general concepts (assuming that the debt was not incurred in anticipation of the contribution: (1) if the owner does not have a "negative capital account", no taxable gain will be recognized; (2) even if the owner has a "negative capital account", no taxable gain will be recognized if the debt on the property is to remain in place following the transfer of the property to the OP; and (3) if the debt is to be replaced or refinanced, whether gain is recognized depends on upon several factors (including the terms of the replacement debt and the extent to which the property owner is considered to "share" in other debt of the OP), but the amount of the taxable gain recognized in any event will not exceed the amount of the owner's "negative capital account."

With respect to both the REIT and the sponsors, the UPREIT structure provides more flexibility in allocations especially for depreciation than those of a straight REIT structure since an UPREIT structure utilizes partnership rules and a straight REIT structure is limited to the less flexible corporate rules.

Also there are estate planning benefits. The tax law provides that the tax basis of a property "steps up" from adjusted basis to the property's fair market value when the owner dies.

Means that an investor can contribute an appreciated real estate investment to an UpREIT partnership, defer paying tax on the gain and, provided the taxpayer holds the UpREIT partnership interest at death, can completely avoid ever paying tax on the gain.

The partnership interest can be passed to the real estate investor's heirs who could either sell the partnership interest or convert the partnership interest into cash or REIT shares the next day without paying any income tax. Nevertheless there may be estate tax issues there.

SO: tax-adviser should be consulted to be sure the investor has addressed estate-planning issues to take full advantage of the means of avoiding tax.

Disadvantages

There are some disadvantages to the UPREIT structure. First, the UPREIT structure adds a level of complexity which does not exist in a straight structure (see following discussion). Second, because the UPREIT structure allows the contributing property partners to defer some or all of their tax liability, the REIT may be allocated less tax depreciation or more tax gain on sale of contributed appreciated property than it would under the straight REIT structure. In a straight REIT structure, full gain is recognized by the transferor on the transfer and full basis step-up is available to the REIT. Third, there may be a conflict of interest between the REIT and the contributing partners with regard to a disposition of contributed appreciated property because such sale would trigger any remaining deferred gains to the contributing partner. This is usually dealt with by negotiating a certain holding period with the partnership so that the general partner can't trigger the tax liability of the limited partners.

Pitfall No. 2

Possible Disguised Sale Under IRC Section 707. If a property contributing partner receives cash in addition to receiving OP Units as part of the contribution of property, some or all of the cash may be taxable under the "disguised sale" rules. In addition, the disguised sale rules provide that a contribution of encumbered property to a partnership constitutes a sale to the extent the contributor's share of liabilities are reduced, unless the liabilities are "qualified liabilities". Qualified liabilities are defined as liabilities that are more than two years old, not incurred in anticipation of the contribution to a partnership, incurred for capital expenditures (tracing rule), and trade payables. For liabilities that do not meet one of these tests, the contributing partner would have to rebut the presumption that the liabilities were incurred in anticipation of the contribution.

DownREIT

A DownREIT operates similarly by using a partnership to acquire appreciated properties from investors on a tax-deferred basis. EXCEL formed the first DownREIT in early 1994.

The significant difference between the DownREIT structure and an UpREIT is that the REIT has formed a partnership with the property contributor only with respect to the contributor's properties.

Most of the REIT's real estate investments will be held directly by it or through other partnerships that have no relationship to the DownREIT partnership.

Investors should be wary because a number of complicated partnership tax issues are involved with structuring any contribution of real estate to a REIT partnership. An investor should seek advise from a tax adviser and should combine the partnership contribution with a sophisticated estate plan.