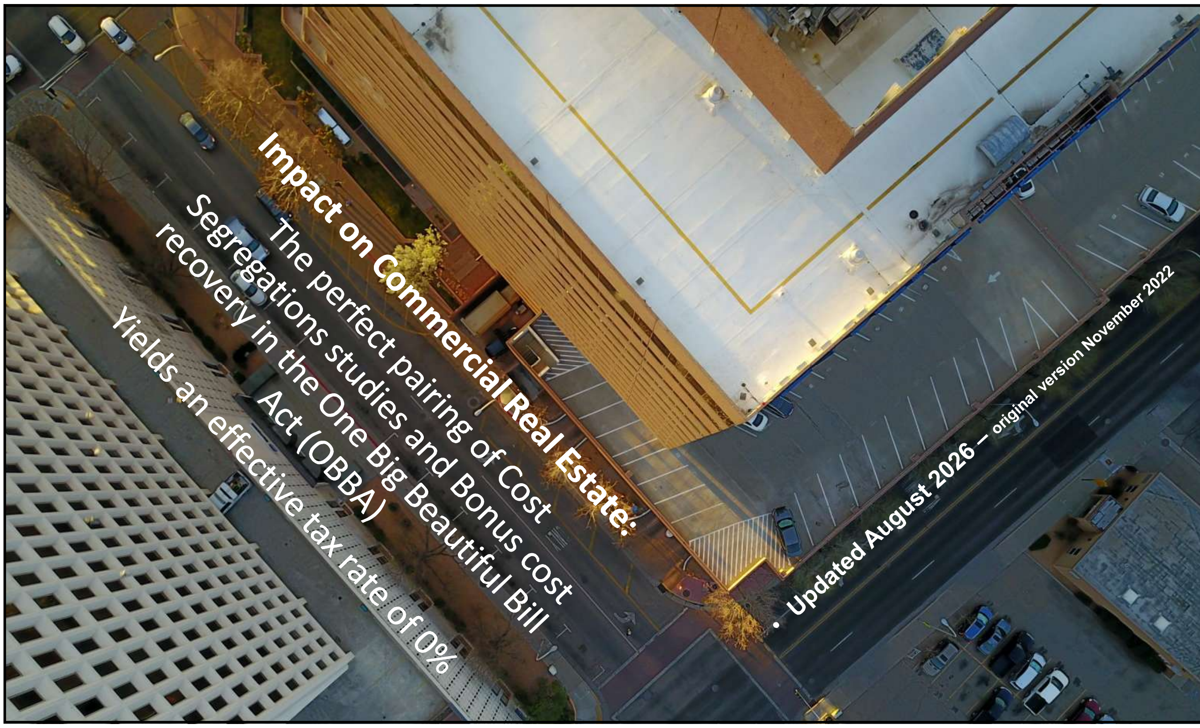


1

Sample Case Study: Taxation in CRE

- Straight line Cost Recovery
- Cost Segregation Cost Recovery
- 2018 Changes in tax law under Tax Cuts and Jobs Act (temporary) and OBBBA (permanent)

2

Planning for taxation is like…

3

Agenda:

1. Benefits of owning commercial real estate
2. Introduction to case study property – sound economics on its own
3. Benefit of Cost Recovery
4. Benefit of Cost Segregation studies
5. Benefit of 2018 tax changes - 2018 Changes in tax law under Tax Cuts and Jobs Act now OBBBA
6. Comparison of #3-#5
7. How to drive your effective tax rate to 0.0%
8. Bonus Round – are you fulltime in commercial real estate?

4

Case Study:

715 Fruit NW

Fourplex

Parts 2-3:

- ✓ Introduction to case study property – sound economics on its own
- ✓ Benefit of Cost Recovery

Investment Summary for Downtown Fourplex

Additional resources	
Virtual Tour **Main** House:	www.nmapartment.com/715fruit3d2
Virtual Tour 715 1/2:	www.nmapartment.com/715fruithalf
Virtual Tour Unit A	www.nmapartment.com/715fruit3d
Virtual Tour Unit B	www.nmapartment.com/fruitb7153d
Register for additional info:	www.nmapartment.com/715fruit
Seller Concession to Buyer:	**NMAA-2570715**

5

NM Apartment Advisors Financial Overview for: **Fruitful Fourplex** 715 Fruit NW

Prepared by: Todd Clarke CCIM 6/8/2026 **"AS IS" Condition**

Unit/Rent Summary

#	Type	Unit/Exp	Approx Size	Owners Actual Rents	Street Rents	Potential Downtown Rents	Actual Rent $/sf	Total Actual (E)	Total Max Rent for this type (C)	Total Market Potential (A)	Total sf
1	2/1		1,095	$ 1,645	$ 1,645	$ 1,645	$ 1.50	$ 1,645	$ 1,645	$ 1,645	1,095
1	0/1		565	$ 875	$ 875	$ 950	$ 1.55	$ 875	$ 875	$ 950	565
2	1/1		500	$ 850	$ 850	$ 1,292	$ 1.70	$ 1,700	$ 1,700	$ 2,584	1,000
4	total units/Avg. unit Size =		665	$ 1,055	$ 1,055	$ 1,295		$ 4,220	$ 4,220	$ 5,179	2,660
				Avg Actual Rent=	$ 1,055	$ 1.00	Annualized =	$ 50,640	$ 50,640	$ 62,148	

Benchmarks		Actual	Proforma
Offering Price	**$612,369**		
$/unit	$153,092		
$/sf	$230.21		
GRM		12.09	9.85
CAP Before Reserves		5.41%	6.78%
CAP After Reserves		5.41%	6.78%
Cash on Cash		0.06%	5.55%
DCR=		1.00	1.26
Walk Score: 77; Transit Score: 56; Bike Score: 85			

Income					
A.	**Total Potential Market Income**		**$**	**62,148**	
B.	Less: loss to market lease		$	11,508	19%
C.	**Total Potential Income (Street)**		**$**	**50,640**	
D.	Less: Loss to lease		$	-	0%
E.	**Total Income**		**$**	**50,640**	
F.	Less: vacancy	5.0%	$	2,532	Estimate
G.	**Effective Rental Income**		**$**	**48,108**	
H.	Plus: Other Income		$	-	
I.	**Gross Operating Income**		**$**	**48,108**	

Expenses (Annual)	EOY 2025	$/unit	%	Based on:			Proforma 2027	$/unit	%	Based on: Forthcoming yr. Income: Line C - F + H			
Real Estate Taxes	$5,318	$1,330	11%	2025 Actual Amount			$7,565	$1,891	12%	Est. for new market value @ 79%			
Personal Property Taxes				assessed at		$340,094				$ 483,772 est. assmt			
Property Insurance	$2,799	$700	6%	Owner Actual 2025			$2,883	$721	5%	Potential 2027 = 2025 + 3%			
Property Management:													
Off Site Management				Owner self manages						Likely Owner Occupant			
Taxes/Workman's Compensation													
Repairs and Maintenance	$2,886	$722	6%	Estimate			$2,973	$743	5%	Potential 2027 = 2025 + 3%			
Utilities:													
Water, Sewer, & Garbage	$2,441	$610	5%	Estimate			$2,514	$629	4%	Potential 2027 = 2025 + 3%			
Gas													
Electric													
Cable													
Internet	$1,500	$375	3%	Estimate			$1,545	$386	2%	Potential 2027 = 2027 + 3%			
Miscellaneous	$25	$6	0%	Estimate			$26	$6	0%	Potential 2027 = 2027 + 3%			
Cleaning				repairs+unit turn+reserve=8to10%									
Reserve for replacement													
Total Operating Expenses	$14,970	$3,742	31%				$17,506	$4,376	28%				
Net Operating Income	**$33,138**	$8,285					**$41,535**	Potential Market less 5% vacancy + other income					
Conventional - 25% down	ADS	Loan	LTV	Pmt	Term	Interest Rate	ADS	Loan	LTV	Pmt	Term	Interest	
Less: Annual Debt Service	$33,043	$ 459,277	75%	$2,754	30	6.00%	$33,043	$ 459,277	75%	$2,754	30	6.00%	
Cash Flow Before Taxes	**$95**						**$8,492**						

Benefits:

- Cap rate
- Cash on cash
- Income

6

			Year 1	2	3	4	5	Calculated for 1st year of next owners, ownership 6
Total Potential Market Income	4.0%	Increases	$62,148	$64,634	$67,219	$69,908	$72,704	$75,613
2 Less: loss to market lease	18.5%		$11,508	$11,968	$12,447	$12,945	$13,463	$14,001
3 Total Potential Income (Max Rent)			$50,640	$52,666	$54,772	$56,963	$59,242	$61,611
4 Less: Loss to lease	0.0%		$0	$0	$0	$0	$0	$0
5 Total Income			$50,640	$52,666	$54,772	$56,963	$59,242	$61,611
6 Less: vacancy	5.0%		$2,532	$2,633	$2,739	$2,848	$2,962	$3,081
7 Effective Rental Income			$48,108	$50,032	$52,034	$54,115	$56,280	$58,531
8 Plus: Other Income	2.0%	Increases	$0	$0	$0	$0	$0	$0
9 Gross Operating Income			$48,108	$50,032	$52,034	$54,115	$56,280	$58,531
Total Operating Expenses	1.5%	Increases	$14,970	$15,194	$15,422	$15,653	$15,888	$16,126
Net Operating Income			$33,138	$34,838	$36,612	$38,462	$40,391	$42,404
			$459,277					
Mortgage Balance			$453,637	$447,649	$441,292	$434,543	$427,377	
ADS			$33,043	$33,043	$33,043	$33,043	$33,043	
- Principal Reduction			$5,640	$5,988	$6,357	$6,749	$7,166	
= Mortgage interest			$27,403	$27,055	$26,686	$26,294	$25,878	
- cost recovery (annual)	27.5 yrs (**1.**	90%	$19,207	$20,041	$20,041	$20,041	$19,207	includes mid mon
= Taxable Income			-$13,472	-$12,258	-$10,116	-$7,873	-$4,693	
Tax on income at ordinary income rate of	**2.**	35%	$0	$0	$0	$0	$0	
NOI			$33,138	$34,838	$36,612	$38,462	$40,391	
- Annual Debt Service			$33,043	$33,043	$33,043	$33,043	$33,043	
= **Cash Flow Before Tax**			$95	$1,795	$3,568	$5,418	$7,348	
- Less Ordinary Income Tax			$0	$0	$0	$0	$0	
= **Cash Flow After Tax**			$95	$1,795	$3,568	$5,418	$7,348	

Sales Worksheet

Calculation of Adjusted Basis			
1 Basis at Acquisition		$612,369	
2 + Capital Additions			
3 -Cost Recovery (Depreciation) Taken		$98,537	
4 =Adjusted Basis at Sale		$513,832	
Calculation of Capital Gain			
Disposition CAP Rate	5.4%		
5 Sale Price		$783,593	
6 -Costs of Sale	8.0%	$62,687	
7 -Adjusted Basis at Sale		$513,832	
8 =Gain or (Loss)		$207,074	
9 -Straight Line Cost Recovery (limited to gain)		$98,537	
# =Capital Gain from Appreciation		$108,537	
Calculation of Sales Proceeds after tax			
# Sale Price		$783,593	
# -Cost of Sale		$62,687	
# -Mortgage Balance(s)		$427,377	
# **=Sale Proceeds Before Tax**		$293,529	
# -Tax: Straight Line Recapture at	25.0%	$24,634	**2.**
# -Tax on Capital Gains at	20.0%	$21,707	
# **=SALE PROCEEDS AFTER TAX:**		$247,187	**3.**

IRR Before tax = 15.5%

n	$	
0	$ (153,092)	
1	$95	
2	$1,795	
3	$3,568	
4	$5,418	
5	$7,348 +	$293,529

IRR After tax = 11.8%

n	$	
0	$ (153,092)	
1	$95	
2	$1,795	
3	$3,568	
4	$5,418	
5	$7,348 +	$247,187

Investor's Effective Tax Rate = 24%

As a commercial real estate investor, the federal tax code gives you three advantages compared to other investments including:

1. Deduct your annual mortgage interest before you calculate your taxable amount;

2. Deduct your cost recovery/depreciation before you calculate your taxable amount, in the future when you sell the property, you only pay back 25% of the benefit you received;

3. Your long term profit, or capital gain, is taxed at 20%

The combination of these benefits could help lower an investor's effective federal tax rate from 35% federal tax rate to only 24%.

Benefits:

- Income appreciation
- Interest deduction
- Cost Recovery (C/R Straight line)
- C/R taxed at 25%
- Capital gains (profit) taxed at 20%

7

Part 4:

Cost Segregation:

This was last owner

CSSI®
Cost Segregation Services Incorporated

August 16, 2022

Mr. Todd Clarke
Managing Partner
Casitas Clarke, LLC
524 Central SW, Suite 801
Albuquerque, NM 87102

Dear Mr. Clarke:

This letter summarizes the results of the cost segregation study we have performed for your property located at 715 Fruit Avenue NW, Albuquerque, NM 87102. The purpose of our study was to identify certain assets of your property that could be classified into tangible personal property and other tangible property (IRC Section 1245 Property) and land improvements. Through our analysis we were able to segregate the costs of your assets into those categories listed as follows:

5 - Year Personal Property	$57,373.89
15 - Year Real Property	$14,665.18
27.5 - Year Real Property	$242,960.93
Total Project Cost Reviewed	**$315,000.00**

This letter and the accompanying report are solely for the use of segregating the costs of the subject facility, and are not to be referred to or distributed for any other purpose.

Please recognize that in accordance with IRS regulations, the taxpayer is required to show the cost basis and depreciation allowance for each item. Accordingly, we recommend that sufficient records and documentation are maintained to meet the IRS requirement.

8

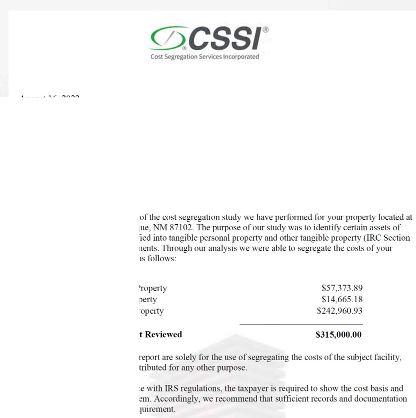
Straight line cost recovery

715 Fruit NW

units	4				
sf	2,498	sf			
Purchase Price	$ 612,369				
Purchase Date	9/1/2026				
Allocation to improvements	85%	**Front**	**Rear**	**Check**	
Improvement $	$ 518,065	$351,775	$166,289	$518,065	
Traditional Cost Recover period	27.5	years - w/o mid month convention			
Annual Cost Recovery Available	$ 18,839	per year			

9

Cost Segregation Study


CSSI®
Cost Segregation Services Incorporated

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as follows:

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operty	$242,960.93
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715 Fruit NW

units	4				
sf	2,498	sf			
Purchase Price	$ 612,369				
Purchase Date	9/1/2026				
Allocation to improvements	85%	**Front**	**Rear**	**Check**	
Improvement $	$ 518,065	$351,775	$166,289	$518,065	
Traditional Cost Recover period	27.5	years - w/o mid month convention			
Annual Cost Recovery Available	$ 18,839	per year			

Cost Segregation Cost Recovery Report **Breakdown** IRC 1245 Tangible Property

			Per year
15%	5 year personal property	$ 94,360	$ 18,872
4%	15 year real property	$ 24,119	$ 1,608
65%	27.5 year real property	$ 399,586	$ 14,530
		$ 518,065	$ 35,010

86% Cost Segregation more than straight-line cost recovery

86%
increase in
tax benefit

10

Part 5:

Changes in Federal Tax Law 2018 - Tax Cuts and Jobs Act

IRS

Help | News | English | Chari

File Pay Refunds Credits & Deductions Forms & Instructions

Home / News / Tax Reform / Tax Cuts and Jobs Act: A comparison for businesses

Tax Cuts and Jobs Act: A comparison for businesses

What was the 2018 Tax Cut and Jobs Act and was temporary is now the One Big Beautiful Bil Act and is permanent

https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-a-comparison-for-businesses

Depreciation	2017 Law	
Temporary 100 percent expensing for certain business assets	Certain business assets, such as equipment and buildings, are depreciated over time. Bonus depreciation for equipment, computer software, and certain improvements to nonresidential real property allows an immediate deduction of 50% for equipment placed in service in 2017, 40% in 2018, and 30% in 2019. Long-lived property generally is not eligible. The phase down is delayed for certain property, including property with a long production period.	TCJA temporarily allows 100% expensing for business property acquired and placed in service after Sept. 27, 2017 and before Jan. 1, 2023. The 100% allowance generally decreases by 20% per year in taxable years beginning after 2022 and expires Jan. 1, 2027. The law now allows expensing for certain film, television, and live theatrical productions, and used qualified property with certain restrictions. For more information, see Tax Reform: Changes to Depreciation Affect Businesses Now and New 100-percent depreciation deduction for businesses.

11

Cost Segregation +OBNBA

715 Fruit NW

units	4				
sf	2,498	sf			
Purchase Price	$ 612,369				
Purchase Date	9/1/2026				
Allocation to improvements	85%	**Front**	**Rear**	**Check**	
Improvement $	$ 518,065	$351,775	$166,289	$518,065	
Traditional Cost Recover period	27.5	years - w/o mid month convention			
Annual Cost Recovery Available	$ 18,839	per year			

	Cost Segregation Cost Recovery Report	**Breakdown**	IRC 1245 Tangible Property	Ratio of Bonus Cost Recovery	
			Per year		100% bonus
15%	5 year personal property	$ 94,360	$ 18,872	100%	$ 94,360
4%	15 year real property	$ 24,119	$ 1,608	100%	$ 24,119
65%	27.5 year real property	$ 399,586	$ 14,530		$ -
		$ 518,065	$ 35,010		**$ 118,479**

529% increase in tax benefit

86% Cost Segregation more than straight-line cost recovery

529% Cost Segregation more than straight-line cost recovery

12

Cost Segregation +2018 - Tax Cuts and Jobs Act

715 Fruit NW

units	4			
sf	2,498 sf			
Purchase Price	$ 372,340			
Purchase Date	4/2/2021			
Allocation to improvements	85%	**Front**	**Rear**	**Check**
Improvement $	$ 315,000	$213,891	$101,109	$315,000
Traditional Cost Recover period	27.5	years - w/o mid month convention		
Annual Cost Recovery Available	$ 11,455	per year		

Cost Segregation Cost Recovery Report	**Breakdown**	IRC 1245 Tangible Property					
		Per year	Ratio of Bonus Cost Recovery	100% bonus	Ratio of Bonus Cost Recovery (2023)	80% bonus	
5 year personal property	$ 57,374	$ 11,475	100%	$ 57,374	80%	$ 45,899	
15 year real property	$ 14,665	$ 978	100%	$ 14,665	80%	$ 11,732	
27.5 year real property	$ 242,961	$ 8,835		$ -		$ -	
	$ 315,000	$ 21,287		**$ 72,039**		**$ 57,631**	$ 14,408 Benefit if closed this year

403% increase in tax benefit

86% Cost Segregation more than straight-line cost recovery

If closed in 2022, 529% Cost Segregation more than straight-line cost recovery

403% Cost Segregation more than straight-line cost recovery

Bonus Cost recovery for 2018-2022	100%
Bonus Cost recovery for 2023	80%
Bonus Cost recovery for 2024	60%
Bonus Cost recovery for 2025	40%
Bonus Cost recovery for 2026	20%

13

Part 6:

Comparison of tax benefits

14

Straight line cost recovery

715 Fruit NW

units	4	
sf	2,498	sf
Purchase Price	$ 372,340	
Purchase Date	4/2/2021	
Allocation to improvements	85%	
Improvement $	$ 315,000	
Traditional Cost Recover period	27.5	years - w/o mid month convention
Annual Cost Recovery Available	$ 11,455	per year

15

Part 7:

How to drive your effective tax rate to 0.0%

16

IRR before

- Straight line cost recovery,
- No Cost Segregation
- No, bonus depreciation
- 18.0% rate

		Year 1	2	3	4	5	6 (Calculated for 1st year of next owners, ownership)
Total Potential Market Income	4.0% Increases	$62,148	$64,634	$67,219	$69,908	$72,704	$75,613
2 Less: loss to market lease	18.5%	$11,508	$11,968	$12,447	$12,945	$13,463	$14,001
3 Total Potential Income (Max Rent)		$50,640	$52,666	$54,772	$56,963	$59,242	$61,611
4 Less: Loss to lease	0.0%	$0	$0	$0	$0	$0	$0
5 Total Income		$50,640	$52,666	$54,772	$56,963	$59,242	$61,611
6 Less: vacancy	5.0%	$2,532	$2,633	$2,739	$2,848	$2,962	$3,081
7 Effective Rental Income		$48,108	$50,032	$52,034	$54,115	$56,280	$58,531
8 Plus: Other Income	2.0% Increases	$0	$0	$0	$0	$0	$0
9 Gross Operating Income		$48,108	$50,032	$52,034	$54,115	$56,280	$58,531
Total Operating Expenses	1.5% Increases	$14,970	$15,194	$15,422	$15,653	$15,888	$16,126
Net Operating Income		$33,138	$34,838	$36,612	$38,462	$40,391	$42,404
		$459,277					
Mortgage Balance		$453,637	$447,649	$441,292	$434,543	$427,377	
ADS		$33,043	$33,043	$33,043	$33,043	$33,043	
- Principal Reduction		$5,640	$5,988	$6,357	$6,749	$7,166	
= Mortgage interest		$27,403	$27,055	$26,686	$26,294	$25,878	
- cost recovery (annual)	27.5 yrs @ 85%	$18,140	$18,928	$18,928	$18,928	$18,140	includes mid mon
= Taxable Income		-$12,405	-$11,145	-$9,002	-$6,760	-$3,626	
Tax on income at ordinary income rate of	35%	$0	$0	$0	$0	$0	
NOI		$33,138	$34,838	$36,612	$38,462	$40,391	
- Annual Debt Service		$33,043	$33,043	$33,043	$33,043	$33,043	
= **Cash Flow Before Tax**		$95	$1,795	$3,568	$5,418	$7,348	
- Less Ordinary Income Tax		$0	$0	$0	$0	$0	
= **Cash Flow After Tax**		$95	$1,795	$3,568	$5,418	$7,348	

Sales Worksheet

Calculation of Adjusted Basis		
1 Basis at Acquisition		$612,369
2 + Capital Additions		
3 -Cost Recovery (Depreciation) Taken		$93,063
4 =Adjusted Basis at Sale		$519,306
Calculation of Capital Gain		
Disposition CAP Rate	5.4%	
5 Sale Price		$783,593
6 -Costs of Sale	8.0%	$62,687
7 -Adjusted Basis at Sale		$519,306
8 –Gain or (Loss)		$201,600
9 -Straight Line Cost Recovery (limited to gain)		$93,063
# =Capital Gain from Appreciation		$108,537
Calculation of Sales Proceeds after tax		
# Sale Price		$783,593
# -Cost of Sale		$62,687
# -Mortgage Balance(s)		$427,377
# **=Sale Proceeds Before Tax**		$293,529
# -Tax: Straight Line Recapture at	25.0%	$23,266
-Tax on Capital Gains at	20.0%	$21,707
# less carry forward loss		
# **=SALE PROCEEDS AFTER TAX:**		$248,556

IRR Before tax = 15.5%

n	$	
0	$ (153,092)	
1	$95	
2	$1,795	
3	$3,568	
4	$5,418	
5	$7,348 +	$293,529

IRR After tax = 11.9%

n	$	
0	$ (153,092)	
1	$95	
2	$1,795	
3	$3,568	
4	$5,418	
5	$7,348 +	$248,556

Investor's Effective Tax Rate = 23%

17

IRR

100% of benefit if taken in 2027

- Note loss carry forward years 2-5 and in sale
- Drops effective tax rate to 0.0%

		Year 1	2	3	4	5	6 (Calculated for 1st year of next owners, ownership)
…otential Market Income	4.0% Increases	$62,148	$64,634	$67,219	$69,908	$72,704	$75,613
… loss to market lease	18.5%	$11,508	$11,968	$12,447	$12,945	$13,463	$14,001
3 …otal Potential Income (Max Rent)		$50,640	$52,666	$54,772	$56,963	$59,242	$61,611
4 Less: Loss to lease	0.0%	$0	$0	$0	$0	$0	$0
5 Total Income		$50,640	$52,666	$54,772	$56,963	$59,242	$61,611
6 Less: vacancy	5.0%	$2,532	$2,633	$2,739	$2,848	$2,962	$3,081
7 Effective Rental Income		$48,108	$50,032	$52,034	$54,115	$56,280	$58,531
8 Plus: Other Income	2.0% Increases	$0	$0	$0	$0	$0	$0
9 Gross Operating Income		$48,108	$50,032	$52,034	$54,115	$56,280	$58,531
Total Operating Expenses	1.5% Increases	$14,970	$15,194	$15,422	$15,653	$15,888	$16,126
Net Operating Income		$33,138	$34,838	$36,612	$38,462	$40,391	$42,404
		$459,277					
Mortgage Balance		$453,637	$447,649	$441,292	$434,543	$427,377	
ADS		$33,043	$33,043	$33,043	$33,043	$33,043	
- Principal Reduction		$5,640	$5,988	$6,357	$6,749	$7,166	
= Mortgage interest		$27,403	$27,055	$26,686	$26,294	$25,878	
- cost recovery (annual)	CSSI+OBBBBA yrs @ 85%	$118,479	$14,530	$14,530	$14,530	$14,530	includes mid mon
= Taxable Income		-$112,744	-$6,747	-$4,604	-$2,362	-$16	
Tax on income at ordinary income rate of	35%	$0	$0	$0	$0	$0	
NOI		$33,138	$34,838	$36,612	$38,462	$40,391	
- Annual Debt Service		$33,043	$33,043	$33,043	$33,043	$33,043	
= **Cash Flow Before Tax**		$95	$1,795	$3,568	$5,418	$7,348	
- Less Ordinary Income Tax		$0	$0	$0	$0	$0	
= **Cash Flow After Tax**		$95	$1,795	$3,568	$5,418	$7,348	

Sales Worksheet

Calculation of Adjusted Basis			
1 Basis at Acquisition		$612,369	
2 + Capital Additions			
3 -Cost Recovery (Depreciation) Taken		$176,599	
4 =Adjusted Basis at Sale		$435,770	
Calculation of Capital Gain			
Disposition CAP Rate	5.4%		
5 Sale Price		$783,593	
6 -Costs of Sale	8.0%	$62,687	
7 -Adjusted Basis at Sale		$435,770	
8 =Gain or (Loss)		$285,136	
9 -Straight Line Cost Recovery (limited to gain)		$176,599	
# =Capital Gain from Appreciation		$108,537	
Calculation of Sales Proceeds after tax			
# Sale Price		$783,593	
# -Cost of Sale		$62,687	
# -Mortgage Balance(s)		$427,377	
# **=Sale Proceeds Before Tax**		$293,529	
# -Tax: Straight Line Recapture at	25.0%	$44,150	
-Tax on Capital Gains at	20.0%	$21,707	
# less carry forward loss		-$126,474	
Net Tax		-$60,616	carry to next deal
# **=SALE PROCEEDS AFTER TAX:**		$293,529	

IRR Before tax = 15.5%

n	$	
0	$ (153,092)	
1	$95	
2	$1,795	
3	$3,568	
4	$5,418	
5	$7,348 +	$293,529

IRR After tax = 15.5%

n	$	
0	$ (153,092)	
1	$95	
2	$1,795	
3	$3,568	
4	$5,418	
5	$7,348 +	$293,529

Investor's Effective Tax Rate = 0%

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Part 9:

Bonus Round of Commercial real estate is your business

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CCIM Institute
Commercial Real Estate's
Global Standard for Professional Achievement

CCIM 104 Summary from Module 3

Module 3 – Federal Taxation

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Module Snapshot / Objectives

Snapshot
- Does not take into account each states (different) tax code, just Federal
- Understand:
  - Basis
  - causes of basis increase/decrease
- Covers:
  - Acquisition
  - Operation
  - Disposition

Objectives
- Classify property assets to the Internal Revenue Code
- Forecast annual cash flows after tax
- Calculate Initial basis
- Allocation C/R
- Forecast sales proceeds after tax
- Tax Treatment for TI's

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Module 3 – Tax Considerations at Acquisition (p3.5)

- Asset Classification
  - Property held for personal residence
  - Property held for sale to consumers (dealer)
  - Property held for use in trade or business (section 1231)
  - Property held as an investment (capital assets, Section 1221)

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Module 3 – Property held for personal residence (p3.5)

- No cost recovery
- Taxable gain is recognized but loss is not.
- Tax deferred exchanges are not allowed, but gain maybe eligible to be excluded if:
  - If primary residence, Section 121, allows for $250,000 gain exclusion for individual and $500,000 gain exclusion for couple

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Module 3 – Dealer Property (p3.5)

- No cost recovery
- Gains and losses on sale are ordinary business income/expense
- No Tax Deferred exchanges
- No installment sale (for tax treatment)

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What is your business? (this is key for the IRS!)

- You are in the business of holding real estate - that is your trade (1231)
- An investor (1221) – holds for the long term with no intention of cost recovery (i.e. land)

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Module 3 – Property held for business
(p3.6)

- Held for more than one year
- Is subject to cost recovery/depreciation
- Gains and losses on the sale of Section 1231 are separately netted from gains and losses on investments from other property types
- Long term capital gains rate
- Losses are ordinary business losses
- Eligible for 1031 deferred exchange

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Module 3 – Property held for business
(p3.6)

- Examples:
  - Retail center with rental income held for long term
  - Owner occupant Office building
  - Industrial bought for intention of holding long term
  - Apartment building held as rental property

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Differences between dealer/investor

Dealer

- Builds to add value
- Builds to sell (quickly?)
- Advertises themselves as a developer (dealer)

Investor

- Buys to add value and/or cash flow
- Buys to own
- Advertises themselves as a investor

What is the magic holding period? (1 year) (how do you demonstrate a year?)

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Summary table

Classification	1231	1221	Dealer	Personal
Cost Recovery	Yes	No	No	No
Capital Gains	Yes	Yes	No	Yes**
Capital Losses	No, *	Yes, limited	No	No
Exchanges	Yes	Yes	No	No,
Installment Sale	Yes	Yes	No	Yes

*Losses are ordinary.
**May be eligible for exclusion under Section 121.

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Allocation Basis (p.3.8) testable concept

- Allocation made at acquisition between % improved and % vacant land (and personal property)
- Vacant land receives no cost recovery
- Investors often use Assessor's ratio (ideally you would choose a 3rd party resource that is defendable)
- Benchmark valued used to determine:
  - Amount of cost recovery deductions
  - Amortization deductions
  - Gain or loss upon disposition

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Initial Basis (p3.11)

- Basis at acquisition: (initial basis)
  - Acquisition price
  - Acquisition costs
  - Does not include prorated rents, or prorated expenses or transfer of deposits)
  - Cost of financing do not impact the basis, but are capitalized and amortized over the life of the loan

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Adjustments to Basis (p3.12)

- Adjustments to basis
  - Allowable cost recover deductions
  - Disposition of a portion of the property
  - Capital improvements

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Cost recovery (p.3.12)

- Types of cost recovery include:
  - Depreciation of improvements (1231)
  - Loan costs amortization – capitalized and amortized
  - Unamortized loan costs
  - Depletion (oil, gas, minerals)

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Cost recovery (p.3.13)

- Allocation
  - Allocated between the:
    - Depreciable
    - And non depreciable portions
- Operation
  - Reduces taxable real estate income
  - Not a cash expense
  - Provides tax shelter
- Methods
  - Residential (27.5)
  - Commercial (39)
  - Mid-Month
  - Cost segregation (not discussed in book)

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Cost recovery (p.3.14) Tables

IRS Cost-Recovery Percentages for Residential Property

	Month											
	1	2	3	4	5	6	7	8	9	10	11	12
Year acquired	3.485	3.182	2.879	2.576	2.273	1.970	1.667	1.364	1.061	0.758	0.458	0.152
Full years held (2-27.5)	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636	3.636
Year of sale	0.152	0.458	0.758	1.061	1.364	1.667	1.970	2.273	2.576	2.879	3.182	3.485

IRS Cost-Recovery Percentages for Non-Residential Real Property

Year	Month											
	1	2	3	4	5	6	7	8	9	10	11	12
Year acquired (1)	2.461	2.247	2.033	1.819	1.606	1.391	1.177	0.963	0.749	0.535	0.321	0.107
Full years held (2-39)	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564	2.564
Year of sale (40)	0.107	0.321	0.535	0.749	0.963	1.177	1.391	1.605	1.819	2.033	2.247	2.461

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Impacts on Cost recovery (p.3.17)

- Capital expenditures
  - Allocated between the:
    - Depreciable
    - And non depreciable portions
- Tenant Improvements
  - Reduces taxable real estate income
  - Not a cash expense
  - Provides tax shelter

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Passive Income and Losses (p.3.23)

- Three types of income:
  - Active
    - Salary, wages, commissions and tips
    - Income from trade or business in which tax payer was a material participant
    - Material participant = involved in operations on a regular, continuous and substantial basis
    - Test (469)
      - Is it the investors primary business?
      - Is the investor frequently on the premises?
      - Does the investor have thorough knowledge?
  - Portfolio
    - Interest, dividends royalties, gains or loss from these
  - Passive
    - Income from a trade or business that tax payer **does not** materially participate

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Example of passive income (p.3.27)

Active Basket
$100,000

Portfolio Basket
($3,000)

Passive Basket
$50,000

	Active basket income	$100,000
+	Portfolio basket loss	(3,000)
+	Passive basket income	50,000
	Income to report	$147,000

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Section 469 (p.3.24) sets our 7 tests – must meet at least one, once a year

1. Participates more than 500 hours a year
2. Participation in the activity for the taxable year constitutes substantially all the participation (more than others)
3. Participates more than 100 hours and is not less than others (partners)
4. Significant participation for the taxable year and exceeds 500 hours
5. Materially participate in the activity for any five taxable years during the last 10
6. Activity is a personal service activity (health, law, engineering, accounting, etc.) for any three taxable years
7. Based on all the facts and circumstances, individual participates in the activity on a regular, continuous and substantial basis.

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The Real Estate professional exception

(p.3.28)

- Section 469(c)7 and material participation
  - Spend more than half your time on (AND)
  - Performs more than 750 hours of services

  - Could include development, redevelopment construction, acquisition, renovation, conversion, renting, operations, management, leasing, etc.
  - (750 hours would be 47 weekends of 2 days x 8 hours)

Example of Applying the Material Participation Exception

	Active Basket	Portfolio Basket
	$100,000	
Apartments	+ (25,000)	$20,000
	$75,000	

If the investor qualifies as a real estate professional, then there are no passive basket activities. The ownership of the apartment building is treated like any other active income or loss.

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This is not tax or accounting advice…

- I am not an accountant, tax advisor, just a Commercial Realtor
- This is based on our own personal tax returns and our situation maybe different than yours
- Please consult with your CPA and your own advisors prior to making decisions

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