

## GENERAL – DIRECT REAL ESTATE INVESTING

### Potential Tax Advantages

Whereas stock dividends are taxable when received, real estate distributions often have tax advantages, such as deduction of depreciation expense, which reduces ordinary taxable income as well as increases the amount of income taxed at capital gains rates (which are significantly lower than ordinary rates).

### Real Estate Pass-Through Income/Loss

Current income or loss allocated from a direct holding in real estate passes through to the investor and is treated as ordinary income or loss. (If the investor is not a real estate professional, pass-through losses are considered passive and may result in “suspended losses” that are not usable on a current basis unless applied against passive income. Any unused suspended losses can be applied upon sale).

### Section 1231 Gain/Loss

Upon sale, Sec. 1231 gains are treated as capital gains, which are currently taxed at 20% (increased in 2013 from 15%). In the case of loss, unlike typical capital losses which can only be used to offset capital gains, Sec. 1231 loss from real estate can be used to offset ordinary income if there are no offsetting 1231 gains in the same tax year. (Note: Net Sec. 1231 losses utilized may convert Net Sec. 1231 gains for the subsequent five years to ordinary income up to the amount of such losses).

### Unrecaptured Section 1250 Gain

Upon sale, any excess sale proceeds over the depreciated basis are considered gain. The portion of gain representing cumulative depreciation taken on real property currently would be taxed at a 25% capital gain rate. This tax rate is quite favorable versus the tax rate on the ordinary income (e.g. potentially 39.6% Federal Tax) that the depreciation expense shielded during the hold. The remainder of the gain at sale would currently be taxed at a 20% capital gain rate.

## DEPRECIATION FOR REAL ESTATE ASSETS

### Depreciation/ Useful Lives

Residential rental property is depreciated over 27.5 years while non-residential rental property (e.g. office, industrial, retail) is depreciated over 39 years. In addition, real estate projects often contain significant personal property that can be depreciated faster, typically over 5-7 years (e.g. furniture & fixtures); and land improvements which are typically depreciated over 15 years (e.g. landscaping, parking lots, pools/amenities). Note - land is not a depreciable asset.

### Cost Segregation Studies

Owners can engage a Cost Segregation Study to potentially more efficiently allocate property basis. The result may be significant tax benefits derived from utilizing shorter recovery periods and accelerated depreciation methods for computing depreciation deductions. Note, such may be more impactful for an asset held directly rather than through a REIT structure. Direct “pass thru entities” allocate net losses to the partners as incurred, subject to passive activity rules. REIT net operating losses (“NOLs”) do not pass through to the shareholders.

## DIRECT INVESTMENT VERSUS REIT STRUCTURE

### REIT Structures

When one invests in real estate through a public or private REIT (Real Estate Investment Trust) the investment for tax purposes is similar to buying a stock, vs. making a direct investment in real estate. In fact, the REIT structure is typically used for the benefit of foreign or tax exempt entities in order to avoid direct holding of US real property that could expose such entities to FIRPTA and UBTI. A REIT structure can be disadvantageous to US tax payers who wish to take advantage of real estate pass-through income, net operating losses (“NOLs”), and/or Sec.1231 losses.