Sale of Investment Property: Scenario A - Cash Shortfall to Pay Income Taxes

Assumptions that result in Cash Shortfall at Tax Time

1 An investor purchases a Duplex on January 1, 1980 for 30,000.
2 The owner allocates $5,000 to the Land and $25,000 to the Building.
3 The property is depreciated over 25 years at $1,000 per year and is fully depreciated by 2005.
4 The owner writes off all capital repairs in the year that they occur, so there are no capitalized improvements for tax purposes.
5 The owner refinances the property in 2006 for $200,000 (FMV $250,000 times 80%) and uses that Cash for other personal use.
6 The owner sells the property on December 31, 2007 for $240,000 (the market is bit down from 2006).

Here is the Tax consequence of the sale.	TAX		**Here is the Cash consequence of the sale.** CASH	
Sale Price	$240,000		$240,000	
Less 5% Commission	$12,000		$12,000	
Other Closing Costs	$5,000		$5,000	
Net Sale Price	$223,000	(A)	$223,000	**Cash Available to Seller**
Tax Basis:				
Purchase Price (1980)	$30,000			
Less Depreciation	($25,000)			**Less**
Plus Capital Improv	$0		$195,000	**Pay-Off Loan Balance**
Net Tax Basis	$5,000	(B)	$28,000	**Net Cash Proceeds at Closing**
				Cash is Not the Tax Gain
Total Long Term Capital Gain	$218,000	(A minus B)		
Total Federal & State Income Tax Due (Owner has no Capital Loss Offsets)	$52,640	→	$52,640	**Tax payable on April 15, 2008**
			$24,640	**Total Overall Cash Shortfall**

Income Tax Calculations & Notes:

1 The depreciation of $25,000 is fully recapped at 25% which equals $6,250.
2 The remaining Capital Gain of $193,000 ($218,000 minus $25,000) is taxed at 15% and equals $28,950.
3 The Total Federal Income Tax due on this transaction is $35,200 ($6,250 + $28,950).
4 The Minnesota State Tax is calculated using $218,000 at 8% and that equals $17,440.
5 The Total Income Tax Due on this transaction is $52,640 (Federal of $35,200 + State of $17,440).
6 Assume there is a Loan Balance of $195,000 to be paid-off at the Closing.

Conclusion The Owner enjoyed the $28,000 of cash at closing, but this cash is NOT the same as Tax Gain. They should have set aside some cash for income taxes when they refinanced in 2006, if there was a possibility of a sale in the near future.

Prepared by William E Bryant CPA, CVA

Sale of Investment Property: Scenario B - Cash Shortfall at Closing due to Market Downturn

Assumptions that result in Cash Shortfall at Closing and Tax Time

1. An investor purchases a Duplex on January 1, 1980 for 30,000.
2. The owner allocates $5,000 to the Land and $25,000 to the Building.
3. The property is depreciated over 25 years at $1,000 per year and is fully depreciated by 2005.
4. The owner writes off all capital repairs in the year that they occur, so there are no capitalized improvements for tax purposes.
5. The owner refinances the property in 2006 for $200,000 (FMV $250,000 times 80%) and uses that Cash for other personal use.
6. The owner sells the property on December 31, 2007 for $210,000 (the market is down a lot from 2006).

Here is the Tax consequence of the sale.	TAX		Here is the Cash consequence of the sale.	CASH	
Sale Price	$210,000			$210,000	
Less 5% Commission	$10,500			$10,500	
Other Closing Costs	$5,000			$5,000	
Net Sale Price	$194,500	(A)		$194,500	**Cash Available to Seller**
Tax Basis:					
Purchase Price (1980)	$30,000				
Less Depreciation	($25,000)				**Less**
Plus Capital Improv	$0			$195,000	**Pay-Off Loan Balance**
Net Tax Basis	$5,000	(B)		$500	**Net Cash Shortfall at Closing**
					Cash Shortfall is Not Tax Loss
Total Long Term Capital Gain	$189,500	(A minus B)			
Total Federal & State Income Tax Due (Owner has no Capital Loss Offsets)	$46,085	→		$46,085	**Tax payable on April 15, 2008**
				$46,585	**Total Overall Cash Shortfall**

Income Tax Calculations & Notes:

1. The depreciation of $25,000 is fully recapped at 25% which equals $6,250.
2. The remaining Capital Gain of $164,500 ($189,500 minus $25,000) is taxed at 15% and equals $24,675.
3. The Total Federal Income Tax due on this transaction is $30,925 ($6,250 + $24,675).
4. The Minnesota State Tax is calculated using $189,500 at 8% and that equals $15,160.
5. The Total Income Tax Due on this transaction is $46,085 (Federal of $30,925 + State of $15,160).
6. Assume there is a Loan Balance of $195,000 to be paid-off at the Closing.

Conclusion The Owner had to come up with $500 of cash at closing. This cash shortfall at Closing is NOT the same as a Tax Loss. If they could have predicted a market downturn, they could have set aside some cash from the refinancing for the cash shortfalls.

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Scenario C: Transfer of Investment Property results in Cash Shortfall at Tax Time due to Relief of Liability

Assumptions that result in Cash Shortfall at Tax Time because of Relief of Liability in Transfer of Property.

1. An investor purchases a Duplex on January 1, 1980 for 30,000.
2. The owner allocates $5,000 to the Land and $25,000 to the Building.
3. The property is depreciated over 25 years at $1,000 per year and is fully depreciated by 2005.
4. The owner writes off all capital repairs in the year that they occur, so there are no capitalized improvements for tax purposes.
5. The owner refinances the property in 2006 for $200,000 (FMV $250,000 times 80%) and uses that Cash for other personal use.
6. The owner Transfers the property on December 31, 2007 to relieve his debt liability, took no cash and walks. No Bankruptcy was filed.

Here is the Tax consequence of the sale.

	TAX	
Sale Price	$195,000	
Less 5% Commission	$0	N/A
Other Closing Costs	$0	Buyer Pays
Net Sale Price	$195,000	(A)
Tax Basis:		
Purchase Price (1980)	$30,000	
Less Depreciation	($25,000)	
Plus Capital Improv	$0	
Net Tax Basis	$5,000	(B)
Total Long Term Capital Gain	$190,000	(A minus B)
Total Federal & State Income Tax Due (Owner has no Capital Loss Offsets)	$46,200	

Here is the Cash consequence of the sale.

CASH	
$195,000	
$0	N/A
$0	N/A
$195,000	**Buyer assumes Debt**
$195,000	**Less Pay-Off Loan Balance**
$0	**Net Cash Shortfall at Closing** No Cash Shortfall
$46,200	**Tax payable on April 15, 2008**
$46,200	**Total Overall Cash Shortfall**

Income Tax Calculations & Notes:

1. The depreciation of $25,000 is fully recapped at 25% which equals $6,250.
2. The remaining Capital Gain of $165,000 ($190,000 minus $25,000) is taxed at 15% and equals $24,750.
3. The Total Federal Income Tax due on this transaction is $31,000 ($6,250 + $24,750).
4. The Minnesota State Tax is calculated using $190,000 at 8% and that equals $15,200.
5. The Total Income Tax Due on this transaction is $46,200 (Federal of $31,000 + State of $15,200).
6. There is a Loan Balance of $195,000 to be paid-off at the Closing and no Bankruptcy has been filed.

Conclusion Owner/Seller may think the transaction is done, but failed to recognize the Tax Consequence.
Transfer of property, even when no cash was taken, is still a taxable event (no Bankruptcy filed).

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