

# Chapter 13

## **TAXATION OF REAL ESTATE**



# **I. REAL PROPERTY TAXES**

# Real Property Taxes

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- Taxes determined in proportion to the value of the property (Ad Valorem Tax) and are paid annually or semi-annually
- Ad Valorem mean taxed “according to value”
  - the higher the value and one’s ability to pay, the higher the tax
  - real property is reassessed each time it is transferred/sold at 100% of selling price (or market value, if higher)

# County Assessor

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- The county officer who is responsible for determining the assessed valuation of land, improvements and personal property used in business
- All real property is assessed except that which is owned by the government
- All tangible personal property which is used in business is also assessed
  - other personal property (intangible) is not assessed or taxed
- Assessor assesses; Board of Supervisors sets rate

# County Tax Collector

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- County officer who collects the property taxes
  - does not assess property or levy taxes
  - requires a tax sale if taxes are not paid

# A. Proposition 13

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- Limits the amount of property taxes to a maximum of 1% of the March 1, 1975 market value
- There is a cumulative maximum increase of 2% in market value for each year since 1975
- Property improvements made after March 1, 1975 are added to value in the year they are made
- If property is newly constructed or sold, the tax is 1% of the sales price or market value, whichever is higher, plus the 2% cumulative increase each succeeding year

# **REAL PROPERTY TAXES AD VALOREM**

"ACCORDING TO VALUE"



## **PROPOSITION 13**

- 1. LIMITS THE AMOUNT OF TAXES TO A 1% OF THE MARCH 1, 1975 MARKET VALUE**
- 2. ALL NEW SALES OR PROPERTY TRANSFERS LIMIT PROPERTY TAXES TO 1% OF SALES PRICE OR THE HIGHER OF FAIR MARKET VALUE**
- 3. TAX INCREASES CAN ONLY GO UP 2% A YEAR**

# B. Real Property Tax Base Transferable (Props 60 & 90)

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- Under the following conditions, homeowners may be permitted to transfer their current Proposition 13 tax base with them when they move:
  - homeowners over the age of 55
  - replacement home of equal or lesser value (<105%)
  - purchased within two years of original sale
  - new home is in the same county, or another participating county

# C. Property Taxes Become a Specific Lien

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- Property taxes due upon real property are, in effect, liens against that specific property
  - for following fiscal year, taxes become a lien on the property as of 1/1 of the current year
- Business personal property taxes (trade fixtures) also become liens against that specific real property on the same tax bill

# D. Property Tax Time Table

- THINK  
“No Darn Fooling  
Around”

VA 88

## REAL PROPERTY TAX YEAR

### PROPERTY TAX TIME TABLE

January 1	July 1	November 1	February 1
Property tax becomes a lien on real property	Fiscal year starts	1st installment is due and delinquent after December 10 at 5:00 P.M.	2nd installment is due and delinquent after April 10 at 5:00 P.M.

<b>NOVEMBER 1</b>	<b>FIRST INSTALLMENT</b>
<b>DECEMBER 10</b>	<b>FIRST INSTALLMENT DELINQUENT</b>
<b>FEBRUARY 1</b>	<b>SECOND INSTALLMENT</b>
<b>APRIL 10</b>	<b>SECOND INSTALLMENT DELINQUENT</b>

*The government fiscal year is July 1-June 30*

# E. Property Tax Proration Problem

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- Who owes whom how much (see p406)?
- Remember: escrow prorates property taxes using old (seller's) assessed value (tax bill)

# Supplemental Property Tax

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- When property changes ownership, or construction is completed, it must be reassessed according to Proposition 13
  - new value is entered on assessment roll as of first of the month following change of ownership or construction completed
  - one or more supplemental tax bills will be issued in addition to regular tax bill which become a lien as of the date of the ownership change or completion of construction

# F. Homeowner's Property Tax Exemption

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- A deduction on the property tax bill of the first \$7,000 of assessed valuation of an owner-occupied property
  - all personal property is exempt from property taxes
  - property must be owner's principal residence on March 1
  - homeowner must file for this between January 1 and April 15 to get the full exemption

# G. Homeowner's and Renter's Property Tax Rebate

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- A percentage of household income on the first \$8,500 of assessed valuation is returned to the taxpayer as determined by Senior Citizen's Property Tax Assistance branch of the State Franchise Tax Board
  - any resident 62 or older with a household income of less than \$12,000
  - persons under 62 who are totally disabled
  - must own and occupy the home
  - a similar program provides rebates to renters

# H. Disabled & Senior Citizen's Property Tax Postponement

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- The State absorbs all or part of the property tax homes of seniors (62 or over, or under 62 if legally disabled)
- A lien is placed on the property for the amount the State has to pay
- This lien is payable when the taxpayer moves or dies
- The State gains title to home if the person dies

# I. Veteran's Exemption

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- Entitled to an annual \$4,000 property tax exemption against the assessed value of one property (principal residence or additional property)
  - for California residents who served in the military during a time of war; also available to:
    - a. widow of veteran
    - b. widowed mother of deceased veteran
    - c. pensioned father or mother of deceased veteran
  - limited to property assessed at under \$5,000 (\$10,000 if married)
    - a. for disabled veterans who qualify, the assessment limit can be raised up to \$100,000

# **REAL PROPERTY TAX EXEMPTIONS**

## **HOMEOWNER'S PROPERTY TAX EXEMPTION**

Deduction on the property tax bill of the first \$7,000 of assessed valuation (owner-occupied).

## **HOMEOWNER'S AND RENTER'S PROPERTY TAX REBATE**

Property tax relief for persons 62 years of age and older with an annual income under \$12,000, and for legally disabled persons under 62 years of age. Rebate is a percentage of household income on the first \$8,500 of assessed valuation.

## **DISABLED AND SENIOR CITIZEN'S PROPERTY TAX POSTPONEMENT**

Persons who are 62 years of age and older and have a household income of less than \$24,000, and persons who are under 62 years of age and legally disabled, qualify for this tax postponement program. State pays all or part of their property tax bill. A lien is placed on the home for the amount paid.

## **VETERAN'S EXEMPTION**

Any California veteran who served in the military during a time of war is entitled to an annual \$4,000 property tax exemption against the assessed value of one property.

# J. Tax Exempt Property

- All federal, state, county, or city government property; the federal government owns 45% of all California land (including park lands)
- Used exclusively by non-profits for religious, charitable, medical, or educational purposes
- 50% of all growing crops, young orchard trees, immature timber, and young grape vines
  - A lessee with possessory interest in oil and gas rights on government-owned property pays taxes

# K. Property Tax Appeals

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- A claim that property has been over-assessed can be taken to the appeals board; the steps:
  - contact the County Board of Equalization (the property tax appeals board)
  - they will consider the case and reduce, increase, or set a new assessment if the property has not previously been assessed
  - property tax appeals should be made between July 2 and August 26

# L. Delinquent Tax Sale (Book Sale)

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- Tax collector publishes a Notice of Intent To Sell list of delinquent properties by June 8
- If taxes aren't paid by June 30, property is 'sold' (via 'book sale') to the State and 5-yr. redemption period then begins
  - property may be redeemed by anyone and Certificate of Redemption obtained upon payment of:
    1. taxes
    2. interest
    3. costs
    4. redemption penalties

# M. Second Sale (After Five Years)

- If owner does not redeem within five years, property will be deeded over to the State
- Former owner may now redeem property only if the State has not sold the property at auction

## PROPERTY TAX SALE

- \* JUNE 8-DELINQUENT TAX LIST PUBLISHED (AFTER NO PAYMENTS FOR 1 YEAR)
- \* JUNE 30-PROPERTY "SOLD" TO STATE
- \* FIVE-YEAR REDEMPTION PERIOD
- \* UNREDEEMED PROPERTY DEEDED TO STATE
- \* COUNTY TAX COLLECTOR PUBLISHES NOTICE OF INTENT TO SELL
- \* PUBLIC AUCTION TAX SALE (FOR CASH)
- \* TAX DEED IS ISSUED

# N. Sale to the Public

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- Delinquent, state-owned property is sold by the county tax collector
  - property is sold to other taxing agencies or to the highest bidder for cash
  - minimum bid is established by the tax collector and approved by the Board of Supervisors
  - purchaser receives a tax deed; title insurance available after one year elapses after tax sale



## **II. SPECIAL ASSESSMENT TAX**

# Special Tax Assessment

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- Levied by the Special Assessment District Board of a city or county, with voter approval, requiring the cost of specific local improvements, such as streets, sewers, irrigation or drainage, to be assessed to the properties which benefit
  - different than property tax revenue, which goes into the General Fund, these funds are applied directly to the cost of these specific improvements
  - bonds are issued to pay for the improvements; assessments repay the bonds over the ensuing period

# Street Improvement Act of 1911

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- Developers can use the Act to construct and improve streets and for sewers construction, however they cannot use the Act to purchase land for subdividing

# B. Mello-Roos Community Facilities Act

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- Municipal bonds issued to fund streets, sewers, and other infrastructure needs before a housing development is built
  - enables the developer to sell units for lower purchase price; buyers pay the annual cost of the bonds through their maturity date
- Seller has primary responsibility to disclose these obligations
  - broker must also disclose to buyer that property is subject to a Mello-Roos levy



# **III. DOCUMENTARY TRANSFER TAX**

# Documentary Transfer Tax

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- A tax that is applied to the consideration paid or money borrowed when transferring property, except for any remaining assumed loans or liens on the property
  - rate is 55 cents for each \$500 of consideration and new borrowed funds or any fraction thereof that exceeds \$100
  - charged to the seller (in No. CA) as part of escrow
  - in most cities the county collects the tax and gives half to the city

# IV. Gift and Estate Taxes

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- For federal purposes, property transferred by gift or inheritance is taxed
  - gift tax while alive
  - estate tax after death
- Fractional annual interests can be ‘gifted’ without tax consequence
  - e.g.,  $1/30$  interest to each of one’s two children over 15 years

# A. Federal Gift Taxes

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- Charged on gifts exceeding \$13,000 annual exemption per donee
- Donor - the person or persons giving the property as a gift
- Donee - the person or persons receiving the gift of property

# B. Federal Estate Taxes


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- A tax return must be filed for the estate of every resident of the United States whose gross estate exceeds \$2,000,000 (in 2006) in value at the date of death
  - repeal of estate tax possible between 2006 and 2010
  - estate tax may be restored in 2011

# C. State Estate Tax

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- There are NO California State Inheritance and Gift Taxes
  - repealed in 1982



**V. FEDERAL, STATE,  
AND LOCAL INCOME  
TAXES**

# Federal and State Income Taxes

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- Taxes charged on personal income by the state and federal governments
  - Californians are among the most taxed individuals in the United States
- Under Federal Income Tax Laws most real estate licensees are considered independent contractors
- According to CA Real Estate Law, licensees are considered employees of the broker



# **VI. TAXES ON PERSONAL RESIDENCE**

# A. Deduction of Interest

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- One of the major tax advantages of owning real estate is the “tax shelter” it affords
  - when buying a first and second home you may finance up to \$1 million (\$1,000,000) with all the interest paid out during the year fully tax deductible
  - an additional deduction is available on the interest from home equity loans, taken for any purpose, even buying a second home, of up to \$100,000 in principal

# B. Deduction of Property Taxes

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- Property taxes on your 1st and 2nd homes are deductible from your income taxes

# C. Deduction of Prepayment Penalties

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- If you pay off or drastically reduce your home loan balance, there may be a prepayment penalty
- These penalties are tax deductible

# D. Sale of Your Residence

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- Every two years, from the sale of one's principal residence
  - no capital gains tax on first \$250,000 (\$500,000 if married) of profit from the sale of a home
  - can only be used once every two years; sold property must be principal residence two of most recent five years
  - a loss on the sale of a personal residence can only be deducted if the property is turned into an income-producing property (by renting it out)



**VII. TAXES FOR  
INCOME  
PRODUCING  
PROPERTIES**

# Investors can annually deduct: \*

- Mortgage Interest on Loans (no maximum)
- Property Taxes
- Prepayment Penalties
- Operating Expenses
- Depreciation of Improvements



\*There is a limitation on high-income investors as to how much 'passive' losses can be taken annually; no such limit on real estate professionals

# A. Depreciation of Investment Property

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- Annual tax deduction based on wear, tear, and obsolescence on investment property
  - does not apply to personal residence
- Depreciation deducted is based only on the cost of building(s) and other improvements
  - land is not depreciable
  - residential @ 27.5 years straight line
  - commercial @ 39 years straight line
- Taxes are paid on this deduction (“recaptured”) when property is sold unless 1031 exchanged

## B. Advantages of "Sale-Leaseback"

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- To seller (now renter) 100% of rents paid are deductible as business expense:
  - receives cash for the building
  - all lease payments can be deducted from income taxes
- To buyer (now has a built-in tenant):
  - the purchase price can be used as the new basis for depreciation and establishes a new depreciation schedule



# VIII. SALE OF REAL PROPERTY

# A. Capital Assets (Gains and Losses)

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- Includes your personal residence (including your second home) and any other real estate because they are long-term investments
- Capital Gains - taxed at a lower rate than is ordinary income
- Capital Losses - can be deducted from capital gains

# Three Capital Gains Tax Rates:

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- 15% maximum capital gains tax rate if held for more than 12 months (long-term)
- 5% capital gains tax rate (held over 1 year) if in the 10% or 15% tax bracket; in 2008, no tax in these brackets
- If held for less than 12 months, taxed at ordinary income tax rates

# B. Federal Income Tax Rates

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- Progressive Taxes - taxes where the rates (percentage paid) increase as the amount to be taxed (income) increases
- Marginal Tax Rate - the rate that the next dollar earned puts you into
- Regressive Taxes - use the same rate no matter how much is spent or earned; sales tax is an example of a regressive tax

# C. Accounting for the Sale of Real Estate

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- The method of determining a profit or loss on the sale of real property is spelled out by the Internal Revenue Service
- Steps 1 and 2 must be completed before determining the profit or loss on a sale (Step 3) – see next slide

# Example:

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(1) Cost Basis (Purchase price)	\$500,000
+ Improvements	200,000
= Adjusted Cost Basis	\$700,000

(2) Sale price	\$1,000,000
+ Depreciation Recapture	30,200
(tax records)	1,030,200
- Sale Expenses	32,500
= Adjusted Sale Price	\$ 997,700

(3) Adjusted Sale Price	\$ 997,700
- Adjusted Cost Basis	700,000
= Gain	\$ 297,700



# **IX. INSTALLMENT SALES AND EXCHANGES**

# A. Installment Sale of Real Estate

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- Sale of real estate in which payments for property extend over more than one calendar year
  - entire gain does not all fall in one tax year
  - this could keep the seller's tax rate on the gain from the sale lower (due to progressive tax system)

# B. Tax-Deferred Exchanges

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- An exchange is transfer of real estate where one property is traded for another
  - if it is an even trade, or if 1031 exchange is accomplished, no capital gains tax will be charged
  - any Boot (consideration given by one party in addition to the traded property) is entirely taxable if it constitutes a gain unless 1031 Exchange is completed
  - such exchanges, favored by investors are complicated and require careful accounting and legal guidance

# Basics of a 1031 Exchange

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- Properties must be like-kind
  - both property being sold and bought need to be held for investment
- Amounts to re-invest: you should trade up; i.e., pay more for new property
- New mortgage should equal or exceed old debt
- Requires facilitator; 3rd party handles \$\$\$ from sale and purchase
- Timing
  - 45 days to identify
  - 180 days to close escrow on new property
- Always consult with a tax expert



# X. WE ARE NOW TAX COLLECTORS

# A. Federal Tax Collection Requirements

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- Persons buying property from foreign investors are required to set aside 10% of the purchase price as a withholding for the Internal Revenue Service
  - generally handled through escrow
- Withholding is kept to insure that the foreign investor will pay taxes on the capital gain
  - citizenship affidavit (FIRPTA form) required from seller
- Both the buyer and broker share liability
- Residential property sold < \$300,000 is exempt

# B. State Tax Collection

## Requirements & Exemptions

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- Persons buying property from foreign or out-of-state investors may be required to set aside 3.5% of the sales price for the Franchise Tax Board
- The exemptions from the buyer withholding 3.5% of the sales are:
  - sales price is \$100,000 or less
  - property is seller's principle residence, under certain conditions
  - seller signs California Residency Declaration
  - seller receives a waiver—Franchise Tax Board Form 567A

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# **XI. OTHER TAXES PAID BY BROKERS**

# A. Business License Taxes (City Income Taxes)

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- A tax against real estate brokerage firms based upon their gross receipts
  - a nominal amount that usually starts at about \$100
  - other taxes may also include employee payroll taxes

## B. Sales Tax

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- Taxed only on tangible personal property
- Successor's (business buyer's) liability is protected by including a provision in the purchase agreement allocating a portion of the purchase price to be held in escrow until a "clearance receipt" is received from the State Board of Equalization

# HOMework

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- Read Chapter 14
- Study for quiz
- Continue reading your supplemental text and be prepared to give oral book report

# Chapter 13 - Summary

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- Real Property Taxes
  - Ad Valorem
- County Assessor
- County Tax Collector
- County Board of Supervisors
- Prop 13
  - Assessed valuation
- Tax due dates
  - No Darn Fooling Around
- 5 year redemption Period
  - Public tax auction
- Homeowner's Property Tax Exemption

# Chapter 13 - Summary

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- Special Assessment Taxes
- Documentary Transfer Tax
- Mello Roos
- Federal Gift Taxes
- Federal Estate Taxes
- Capital gains
- Federal taxes are progressive
- Installment sales
- Tax deferred exchanges
- Foreign Investors