ALEC J. PACELLA

What's Your Basis?

Several years ago, we focused on the concept of cost recovery (also known as depreciation) in a couple of columns. This month, we are going to dig a little deeper into this concept, but before you tune out and flip to a different part of the magazine, ask yourself two questions. First: do you/your company/your clients pay taxes? And second: do you/your company/your clients care more about how much you make or how much you keep? If the answer to these questions is "yes," I would recommend that you read on.

Cost recovery is an acknowledgment by the IRS that real estate is subject to wear and tear over time. To offset this, they allow an owner to recognize cost recovery. The general concept is that the owner's original basis in the real estate is reduced each year as a result of the deprecation of the improvement portion of the real estate. This can be a clear benefit to the owner, as the cost recovery taken each year is deducted from any income each year. The result is a shelter for the owner, as they will be subject to tax on income after recognizing cost recovery, not before. I have simplified this concept and there are numerous nuances associated with the process. This month, we will focus on a specific nuance that occurs at the very beginning of the process – establishing original basis.

Basis is both an accounting and a tax concept. It is the benchmark value that is subsequently used to determine the amount of cost-recovery deduction, amortization deduction and gain or loss when the property is sold. Basis is established at the time of acquisition and must be allocated between the portions of the property that are attributable to land, improvements and, if applicable, personal property. Allocating the original basis is important because land is not subject to cost recovery. But, similar to many things in my life, we'll put that in a box on the shelf and deal with it another day. The focus this month is on the nuances associated with establishing the original basis.

The most common way that original basis is determined is during an outright purchase. When a property is purchased, the basis is the buyer's purchase price of the property. This includes the cash down payment, any mortgages, any other good and valuable consideration and any acquisition costs that may be capitalized and added to the basis. For example, suppose a buyer purchases a property. The original equity is $500,000, the mortgage is $1,500,000, the closing costs are $1,000, the associated legal and title work are $2,000 and the buyer has a phase one study completed at a cost of $5,000. In this instance, the original basis would be the total of all of these or $2,008,000.

Real estate owners will often utilize a strategy commonly called an exchange as a part of their acquisition. The details and nuances associated with exchanges is in a box right next to the box labeled "allocation of basis" and this month, I'm only going to focus on the part of exchanges related to establishing original basis. When completing an acquisition as a part of an exchange, a concept known as "substitute basis" is introduced. Depending on the terms, the substitute basis in the property being acquired may be greater than or less than the adjusted basis in the property being exchanged. The gain not reported on the disposition of one property is subtracted from the value of the property acquired in the exchange, plus the acquisition costs including intermediary fees, to establish the original basis. For example, suppose that a buyer is acquiring a property as a part of an exchange. The value of the property that is being sold is $1,500,000 and the adjusted basis of that property at sale is $800,000. This means that the buyer will have a $700,000 gain on the property they are selling; $1,500,000 value less $800,000 adjusted basis at sale. Switching to the property the buyer is acquiring, we will use the same scenario that is used for the outright purchase scenario above; $2,000,000 value plus $8,000 in total acquisition costs. Because this is a trade, there will also be fees associated with the intermediary, which in this instance are estimated to be $10,000.

Daus, You Know?

BIG DEAL For the past few years, one of the things that I have said that has been missing from our investment market was a "blockbuster sale." With potential sales of Terminal Tower, Key Tower and North Point Tower all swirling in the rumor mill, 2016 may be the year that all changes. *–AP*

Determining the buyer's original basis in the replacement property, we would add the purchase price of $2,000,000 plus the total acquisition costs of $8,000 plus the intermediary fee of $10,000 less the gain associated with the property that is being sold of $700,000. So the substitute basis in the property acquired would be $1,318,000, which is what would then be allocated into land and improvement components.

Sometimes, a property is gifted. When this occurs, the original basis of the donee (or party receiving the property) is usually the same as the adjusted basis of the donor (or party giving the property), plus a proportional share of any gift taxes paid by the donor. However, the total basis may not exceed the property's fair market value at the time of the gifting. Using an example, suppose that the property being gifted has a market value of $2,000,000 and the adjusted basis in the property at the time of gifting is $1,200,000. The original basis in the property for the donee would be $1,200,000; market value of $2,00,000 less gain at the time of gifting of $800,000. Note that gifting will transfer the gain from the person holding the property prior to the gift (or donor) to the person acquiring the property through the gift process (or donee).

Finally, a property may be inherited. The original basis in this instance would be established by the market value of that property at the time of the previous owner's, or decedent's, death – regardless of the decedent's adjusted basis at that time. Once again using our example, suppose that a property has a market value of $2,000,000 and the adjusted basis in the property at the time of the decedent's death is $1,200,000. The original basis for the person inheriting the property would be $2,000,000, the market value at the time of the decedent's death. Any gain, in this instance $800,000, would be the responsibility of the estate of the descendent. P

Alec Pacella, CCIM, senior vice president at NAI Daus, can be reached by phone at 216.455.0925 or by email at apacella@naidaus.com. You can follow him on twitter @dausyouknow or on his blog at http://blog.sbequitiesinc.com.