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Deciphering Depreciation In Real-Estate Tax Laws

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Question: Can investors defer depreciation-recapture tax when they sell property to a private-annuity trust? My understanding of the tax law is that all depreciation is recaptured at the time of sale.

-- *John Paul, Chicago*

John Paul: The tax can be deferred but not because the investor sells the property to the trust. In fact, the investor doesn't sell the property. He transfers it. A private-annuity trust is a trust in which a property owner can transfer ownership of a property (often to his or her children) before completing a sale to a buyer. The trust pays the owner for the property, not in cash, but with a special payment contract called a private annuity that stipulates that payments from the sale go to the owner for the rest of his or her life, essentially in installments.

The trust then sells the property to a buyer, getting cash for the property. In a normal sale, the seller would immediately pay capital-gains tax on the full value of the property. Since the private-annuity contract calls for payments to be made in installments over the seller's life, the seller is only taxed on payments when they are received, instead of all upfront. What's more, the investor can postpone when payments from the trust begin. The amount of each installment payment is determined by Internal Revenue Service life-expectancy tables.

So you see, the property is transferred to the trust, not sold. Investors using the private-annuity contract can defer taxes known as depreciation recapture, in which the IRS recaptures depreciation the owner had previously received deductions for. It's when the trust sells the property to a buyer that capital-gains tax and depreciation-recapture tax kick in proportionally over the life expectancy of the investor, according to Scott A. Leonard, a certified financial planner in Redondo Beach, Calif.

Question: Suppose someone would like to do a 1031 exchange to defer capital-gains taxes on his or her property sale. With an intermediary holding the cash, the investor would like to purchase a limited-partnership interest or umbrella-partnership real-estate investment trust share in a REIT. The property is valued at less than \$20 million, and I've heard that REITs don't want properties valued at less than this. Is this correct? Also, can one exchange a real property into a limited-partnership interest without creating a taxable event?

-- *Kent, location not provided*

Kent: You're correct when you say almost all REITs won't be interested in properties below \$20 million. But there are some that will be interested. Denver-based REIT Dividend Capital Trust, for example, launched a program that makes these kinds of transactions possible for individuals with properties valued at less than \$20 million.

In 1031 exchanges, real-estate owners defer capital-gains taxes on the sale of property by purchasing

(or exchanging it for) another property of equal or greater value. An intermediary usually handles the money in these transactions. Tenant-in-common or TIC programs are a form of 1031 exchanges in which sellers can conduct an exchange by buying a fractional interest in a property.

A REIT can decide to sell TIC interests in a property it owns or is planning to buy. "The key is the combination of an initial 1031 exchange from property owned outright into property owned as a tenant-in-common interest with a REIT," says Louis S. Weller, principal at Deloitte & Touche LLP's tax services group in San Francisco. After a sufficient waiting period -- two years is preferable, Mr. Weller says -- the TIC interest the investor bought from the REIT is contributed to the REIT's operating partnership for OP units. This is known as a 721 transaction, which in itself isn't a taxable event. Thereafter, the OP units are convertible into REIT stock at the unit holder's election, Mr. Weller says. This conversion will be taxable, "so the idea is to defer conversion until liquidity is needed," he says.

-- Mr. Smith is a staff reporter for The Wall Street Journal. His "Building Value Q & A" column appears each month exclusively on RealEstateJournal. [Click here](#) to e-mail him a question about investing in real estate.