



COLORADO REAL ESTATE JOURNAL

THE COMMUNICATION CHANNEL OF THE COMMERCIAL REAL ESTATE COMMUNITY

DECEMBER 2, 2009 – DECEMBER 15, 2009

The impact of state and local taxes on your Colorado RE investment

When one is able to escape from state and local income taxes on disposition of a real estate investment, that can be a welcome relief. Colorado provides such a mechanism if certain requirements are met. But there also are some state and local tax traps that can be an unwelcome surprise. Here are some features of Colorado state and local tax law that can affect how your investment performs:

■ **Colorado capital gain subtraction.** Investors receive reduced tax rate on federal income taxes if the income is considered long-term capital gain. Colorado has no special rate for capital gains – such gains are taxed the same as any other income. The current Colorado income tax rate is a flat 4.63 percent. However, if all of the following requirements are met, Colorado provides a capital gain “subtraction” for Colorado source capital gain. The subtraction is available:

- to individuals, corporations, partnerships, limited liability companies, etc., that do not have overdue state tax liabilities and are not in default on any contractual obligations owed to the state or any local government within Colorado at the time the subtraction is claimed (including uncollectible taxes from a bankruptcy);
- for Colorado source gain from real property located in Colorado (and for certain other assets);
- where the property was acquired on or after May 9, 1994;
- if the property has been



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held continuously for at least five years; and – the gain is included in federal taxable income.

Any gain treated for federal purposes as ordinary income (such as certain depreciation recaptured) will not qualify, but gain taxed at the 28 percent rate may benefit from the Colorado subtraction.

The Colorado capital gain subtraction counts the holding period of property differently than does the federal income tax law. When one exchanges real property in a tax-deferred exchange, for federal purposes, the holding period of the newly acquired property includes the time the exchanged property was held. Not so with the Colorado capital gain subtraction – only the time the property was actually held counts for purposes of the five-year holding period.

When Colorado has a budget surplus, the subtraction can be extended to assets acquired before May 9, 1994, but it has been announced that this won't be the case at least through 2010. The subtraction can be further expanded to apply to assets held for only one year, again based on budget surpluses. Often, advance tax planning can help dispositions qualify when they might not otherwise.

■ **Local real estate transfer**

tax. The TABOR amendment to the Colorado Constitution prohibits any new real estate transfer taxes, but a number of jurisdictions have transfer taxes in place: Aspen, Avon, Breckenridge, Crested Butte, Frisco, Gypsum, Minturn, Ophir, Snowmass Village, Telluride, Vail and Winter Park at rates varying from 1 percent to 4 percent.

Real estate transfer taxes tend to be idiosyncratic and the particular ordinance should be checked when engaging in a transaction. Some localities look only to whether ultimate beneficial ownership changes (thereby facilitating reorganizations and restructuring of ownership without tax) while others are more restrictive. Otherwise, Colorado imposes a nominal 0.01 percent “documentary fee” on most real estate transfers.

■ **State and local sales and use tax.** Colorado is one of a handful of states that imposes sales tax on the “occasional sale” of tangible personal property. Occasional sales are generally sales of property by one not ordinarily in the business of selling that particular type of property. As a result, that sales tax can arise from the sale of the tangible personal property of a business, such as the furniture of a hotel or motel and the furniture, fixtures and equipment (FF&E) of a restaurant. Cities and counties are frequently more rigorous in imposing taxes on transactions (transfer taxes) than the state of Colorado. For example, Denver's sales and use tax laws define a sale most

expansively to include any acquisition of property including by exchange (including for services) as well as purchases for money. It then exempts certain transactions. One effect of these provisions is that Denver can impose a tax upon the *formation* of a partnership or LLC if the partnership or LLC assumes liabilities of the purchaser.

■ **Taxes applicable to resort property renters.** Persons renting a property are required to collect and pay a Colorado state lodging tax on the furnishing of rooms or accommodations including a house, hotel room, guest house, apartment hotel and others. Rentals of fewer than 30 consecutive days are taxable. The tax rate is the same as the state sales tax rate. Furthermore, counties may impose a lodging tax as may municipalities. Unpaid sales taxes are a lien on the property.

Colorado also considers that household furnishings used for the production of income “for any period of time during the taxable year” are subject to the personal property tax. This means that persons who rent their homes even for a single day are required to file a personal property tax schedule and pay personal property tax based on 29 percent of the property's value multiplied by the applicable mill levy.

It often pays to consider the state and local tax issues involved in real estate investments before the investment is made – or before the property is sold.▲