

CAPITAL GAIN TAX RATES: "THE KNOWN, THE UNKNOWN & WHY EXCHANGE NOW"



Compliments of

Throughout much of the 20th century and into the new millennium, capital gains have been taxed at a lower rate than other income or were only partially exposed to taxation. The rationale for the lower rate is that it encourages capital formation and investment, fosters risk-taking and offsets the effect of inflation on capital gains. History has shown the tax rate applied to capital gains and dividends has a substantial impact on the way taxpayers handle income from capital.

The Tax Reform Act of 1986 significantly reduced the differential between capital gain taxes and ordinary income taxes. More recently, the Jobs and Growth Tax Relief Reconciliation Act of 2003 lowered the rates on long-term capital gains to 15% from 20% for taxpayers in the 25% bracket or higher and lowered the 10% rate to 5% for taxpayers in the 10% and 15% tax brackets. These rates became effective May 6, 2003. In 2008, the 15% rate remains the same but the 5% rate is reduced to zero. The Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 extends the Bush era tax cuts until the end of 2012. In 2013, the capital gain rates are set to return to the old 20% and 10%.

SELL TODAY AT A 15% RATE VS. EXCHANGING

Lets compare the after tax result for a taxpayer who sells today at the current 15% maximum rate versus the same taxpayer who elects to defer all capital gain taxes using a 1031 exchange. In each case, the taxpayer sells at a capital gain tax rate of 20% in the future.

Assume the following: A taxpayer is selling an investment property for \$1 million with \$200,000 remaining debt and \$800,000 equity; the taxpayer's adjusted cost basis is \$300,000 and his gain is \$700,000, of which \$200,000 is depreciation recapture (taxed at 25%) and \$500,000 (taxed at 15%) is the remaining economic gain; the taxpayer is in the top Federal tax bracket and their state tax rate is 7%. Also assume the after-tax sale proceeds are reinvested into a mutual fund for 5 years yielding 8% simple interest and the exchange proceeds are reinvested into another investment property with a 25% down payment (75% LTV) and that the investment property appreciates an average of 6% for the next 5 years. Assume five years later the capital gain rate is 20%, the depreciation recapture is \$80,128 (\$320,512 at 25%; \$3,200,000 purchase price - \$700,000 deferred gain = \$2,500,000 / 39 years straight line depreciation of \$64,103/year x 5 years) and the state tax remains at 7%.

- **Sell in 2011:** \$174,000 owed in capital gains (\$50,000 depreciation recapture; \$75,000 Federal taxes; \$49,000 state taxes)
- **Exchange in 2011:** \$0 owed in capital gains (No taxes recognized under IRC Section 1031)
- **Sell/Reinvest after-tax proceeds in a mutual fund:** \$626,000 (\$800,000 - \$174,000 taxes owed)
- **Exchange/Reinvest \$800,000 gross proceeds in property:** \$3,200,000 (4 x \$800,000)
- **5 Years Later - Sell:** \$876,400 in mutual fund assets (Assuming an 8% return - the S & P 500 historical average)
- **5 Years Later - Exchange:** \$1,760,000 equity (\$4,160,000 in value - \$2,400,000 loan)
- **5 Years Later - Paying taxes at 20%:** \$464,225 (\$4,160,000 sales price - \$2,500,000 cost basis = \$1,660,000 x applicable tax rates;) \$80125 depreciation recapture [\$320,512 x 25%]; \$267,900 Federal taxes [\$1,339,500 x 20%]; \$116,200 state taxes [\$1,660,000 x 7%]

The exchanger has \$419,375* more equity and almost a 48% better rate of return - even if paying taxes at a higher 20% rate - than the taxpayer who sells today and paid taxes at 15%. And this calculation does not even include the additional taxes that would be owed after the sale of the mutual fund. Tax deferral and reinvestment of the entire net equity into replacement property yields a better investment return — even if capital gain taxes rates increase to 20%.

* \$1,760,000 equity - \$459,200 taxes = \$1,295,775; After-tax equity 5 years later - \$1,295,775 - \$876,400 = \$419,375



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