

# UNDERSTAND THE IMPACT OF TAX TREATMENT

## "ORDINARY INCOME VS. CAPITAL GAIN"



### Compliments of

With all investments, an important consideration is the amount of the investment return that the investor gets to keep after taxes that really matters. The tax rates differ significantly between ordinary income and capital gains and can have a big impact on after tax returns.

#### ORDINARY INCOME TAXATION

Ordinary income can be simply defined as the income earned from providing services or the sale of goods (inventory). This category includes income earned from interest, wages, rents, royalties and similar income streams. Ordinary income is taxed at different rates depending on the amount of income received by a taxpayer in a given tax year. In 2010, there are currently six tax brackets for taxing ordinary income: 10%, 15%, 25%, 28%, 33%, and 35%. These ordinary income marginal tax brackets are scheduled to expire at the end of 2010. In 2011, the 10% through 28% tax rates will remain the same and the top two rates of 33% and 35% will be replaced with higher rates, 36% and 39.6% respectively.

#### CAPITAL GAIN TAXATION

Capital gains are usually associated with the sale or exchange of property characterized as capital assets. The amount of gain is measured as the difference between the amount received by the taxpayer on the sale less the original purchase price, adjusted through the date of the sale (purchase price plus any improvements less depreciation taken). For more information on the formula to calculate capital gain on the sale of a property, see [Calculating Capital Gain](#).

The category of capital gain taxation is further broken down into long and short term capital gains. If a property is sold within one year of its purchase, the gain is characterized as short-term and taxed at the same marginal rate as the taxpayer's other ordinary income. Thus, at least for short term gains, the tax rates are the same as the taxpayer's ordinary income. On the other hand, if the taxpayer holds the property for more than one year before selling, the gain is characterized as long term capital gain and is taxed at a favorable long term rate.

In 2010, the long term capital gain tax rate is 15% and this reverts on January 1, 2011 to the previous long term rate of 20%. Long term capital gains, on assets held for over one year, are subject to a lesser tax rate than short term capital gains from investments held for less than one year. For more details on capital gain taxes and investment income, see Internal Revenue Service publications 17 and 550, at [www.irs.gov](http://www.irs.gov).

#### TAX DEFERRAL VIA SECTION 1031

Section 1031 of the Internal Revenue Code provides tax deferral for certain exchanges of property held for investment or used in a trade or business. To qualify for deferral, the property relinquished in the exchange must be exchanged for a "like-kind" replacement property. There are a variety of other requirements for deferral including time requirements, property identification and, in some cases, the use of a qualified intermediary to facilitate the exchange transaction to avoid actual or constructive receipt of the proceeds. Click on [delayed exchanges](#) to learn more about the most popular exchange strategy.



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